FEDERAL OPEN MARKET COMMITTEE MEETING TRANSCRIPTS

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Meeting of the Federal Open Market Committee

May 21, 1996

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 21, 1996 starting at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Jordan
Mr. Kelley
Mr. Lindsey
Mr. McTeer
Ms. Phillips
Mr. Stern
Ms. Yellen

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Hoenig and Melzer, and Ms. Minehan, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Lang, Lindsey, Mishkin, Promisel, Rolnick, Rosenblum, Siegman, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Rives, First Vice President, Federal Reserve Bank of St. Louis
Mr. Beebe, Ms. Browne, Messrs. Davis, Dewald, Eisenbeis, Goodfriend, and Hunter, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Boston, Kansas City, St. Louis, Atlanta, Richmond, and Chicago respectively
Mr. Altig, Mses. Chen and Rosenbaum, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and Atlanta respectively

Transcript of Federal Open Market Committee Meeting
May 21, 1996

CHAIRMAN GREENSPAN. Good morning, everyone. First, I would like to acknowledge the fact that this is the first meeting for First Vice President LeGrand Rives of the St. Louis Bank, Senior Vice President Robert Eisenbeis of the Atlanta Bank, and Pauline Chen of the New York Desk. I would like to welcome all of you and request that the rest of us approve the minutes of the March 26 meeting.

VICE CHAIRMAN MCDONOUGH. So move.

SPEAKER(?). So move.

CHAIRMAN GREENSPAN. Without objection. Peter Fisher.

MR. FISHER. Thank you. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter? If not, would somebody like to move ratification of the Domestic Desk operations?

MR. LINDSEY. Move approval.

VICE CHAIRMAN MCDONOUGH. Second.

CHAIRMAN GREENSPAN. Without objection. I will call on Messrs. Prell and Truman at what has to be the earliest possible time that this has occurred.

MR. TRUMAN. Except when the Committee started the meeting at 8:00 in the morning.

CHAIRMAN GREENSPAN. You always throw a monkey wrench into the works!

MR. TRUMAN. People have said that. [Laughter] [Statement--see Appendix.]

MR. PRELL. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for either gentleman?

MR. PARRY. Mike, the core rate of inflation in the forecast increases 1/2 percentage point between the first quarter of this year and the fourth quarter of next year. If one were to assume an unchanged policy and to extrapolate that out into 1998, what do you think would happen to core inflation in 1998?

MR. PRELL. In 1998, economic growth would remain essentially around trend and the unemployment rate around 5-1/2 percent. Our judgment is that the core inflation rate is tending to rise gradually and perhaps it would continue to do so in 1998. We do not think that we are far beyond the NAIRU, and that would mean a very gradual trend in the direction of more inflation.

MR. PARRY. You have a fairly large increase forecast for 1996 and 1997.

MR. PRELL. There are some exacerbating factors, as I emphasized in my briefing, and those are areas where the uncertainties are substantial. But as we looked at the probability distribution in light of developments since the last Greenbook, we felt that we ought to assign a higher expected value to the levels of grain and food prices down the line. That is the most important exacerbating factor.

CHAIRMAN GREENSPAN. What is the timeframe that you assume exists between the increase in grain prices and its effects on poultry, hog, and cattle prices? I will assume that it is in that order of lead times.

MR. PRELL. We noted in the Greenbook that we do not feel that we can pin that down with any certainty. I think we are already seeing this transmission process affecting the poultry area where producers are cutting back on their production levels, and we expect to see a price pass-through there fairly promptly.

CHAIRMAN GREENSPAN. Can't you tell from the futures prices?

MR. PRELL. We have looked at the futures prices and--

CHAIRMAN GREENSPAN. Don't they tell you what average lead times are or can be assumed to be?

MR. STOCKTON. Mr. Chairman, our forecast shows an expectation of higher poultry prices showing through to the retail level more fully by the summer. By late fall or early winter, we would expect to see the higher hog prices show up as increased pork prices in grocery stores. Higher cattle prices would show up early next year.

CHAIRMAN GREENSPAN. That is what I was going to say--that you can make an assumption.

MR. PRELL. We are making assumptions, but there are no guarantees. Certainly, it is our perception that things have started to turn in the cattle area. Whereas, a couple of months ago, we saw the risks that herds would be cut back, the anecdotal evidence suggests that this process is now under way. So, we feel more certain that there will be that pressure several months down the road.

CHAIRMAN GREENSPAN. Governor Lindsey.

Mr. LINDSEY. Mike, my first question is, do we have any evidence yet on how households have financed higher gasoline prices? The increases per month amount to about $10 per car or $20 per household. Is that coming out of savings or out of other consumption?

MR. PRELL. I guess our assumption is that it would probably come out of savings to some degree in the short run. Over time, we would expect people to reallocate their spending and to absorb that elsewhere. But in the very short run, there probably would be some inelasticity. It would not be a one-for-one substitution for other expenditures.

MR. LINDSEY. The move in oil prices in the futures market suggests that the market has changed its expectations toward higher prices going quite a ways out. If you just look at the inventory balances held by the majors, which are now at record lows, why do you think we are going to see a decline in oil prices?

MR. PRELL. There is still an anticipation in the market that oil prices will decline. What happened yesterday, though, is that prices in near-term contracts jumped dramatically after their initial drop. The market reports talked about the closing out of near-term contracts, some short covering, and so on. As we read most of the commentary, though, there is still the expectation that the net effect of the Iraqi oil flow will be to push oil prices down a couple dollars per barrel below what they otherwise would have been. It is recognized that in the near term there is going to be some tendency to rebuild stocks, and that may mean that we are not going to get all of this increased supply benefit passing through to retail energy prices very promptly.

MR. LINDSEY. What is the average price in your underlying assumption?

MR. TRUMAN. We are forecasting a decline in oil import prices to $17 per barrel and in WTI spot prices to around $19.50 per barrel; that is down a couple of dollars from current levels. Our forecast did not assume an Iraqi oil decision at this time, but it did assume that we would get essentially the same amount of oil in 1997, so our forecast had the increased supply occurring 6 months later. We actually have the oil price somewhat higher than the futures prices as of last week, so in some sense all that has happened is an adjustment in the timing. Other than the short-term factors that Mike was referring to, the one argument that you might point to on the further out picture is that one might be led to conclude that this is "it" rather than an assumption that Iraq will be allowed to export much more in the near term. So, the prospect of full Iraqi production coming on stream in the next year or two has gone down. That is the only story that I could pick up on that.

MR. LINDSEY. You are saying that Iraqi oil exports won't exceed 700,000 barrels per day in this period?

MR. TRUMAN. That's right. The probability that it will be 2 million barrels has gone down even as the probability of 700,000 barrels has gone up.

MR. PRELL. In terms of our CPI forecast, if we assume that the price of oil declines a little faster, the contour of the forecast changes in that we have a little less inflation this year than next year. But at this point, we need to monitor what is happening in the markets.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mike, I want to go back to grain prices. One trend of which we are aware is that the percentage of processed food costs that stem from their grain content has come down--quite markedly, actually, over the last twenty years. I was wondering whether the econometric models that we use take that into account and also what the sensitivity of food prices is to changes in grain prices as we look ahead to this period when the grain price increases are expected to pass through to consumers?

MR. PRELL. We are well aware of the calculations that show how the grain in a loaf of bread accounts for just a few cents of its cost. There has been an increase in packaging and distribution costs so that there is less sensitivity to changes in grain prices than in the past. The big kicker here is the meat price story, and there again we are less certain about the timing. There have been changes in the production processes, as we have seen dramatically illustrated in the poultry and pork industries. So, one does have to be a little cautious in following past patterns here, but we think that ultimately this grain price increase is creating a lot of pressure on margins and will lead to reduced supply. That is where the big kicker will come over the forecast period.

CHAIRMAN GREENSPAN. Isn't that inflationary effect related only to feed grain prices? The amount of wheat that is used for feed grains is very small, and as we know breakfast cereal prices went down as the price of wheat went up.

MR. PRELL. Perhaps. I think we need to see what happens with cereal coupons and all of that business.

CHAIRMAN GREENSPAN. Except for its impact on the export markets, wheat has essentially become disassociated from the rest of the economy, whereas corn is a major input into the food chain--actually, corn, soybeans, and soybean meal. Wheat used to be a key factor twenty or thirty years ago, but it isn't any more.

MR. PRELL. That underscores again that, while we know something about a good chunk of this year's wheat crop, we know very little about the corn and soybean crop outlook. We are making a bet, and the markets are making a bet. We are pretty much in line with the markets, but there is going to be a lot of volatility and we are not going to know the outcome for another four or five months. I think one's optimism on this score has to be tempered by the fact that inventories are quite low and demand growth seems to be robust enough that one year of good harvests probably will not relieve the pressures entirely.

CHAIRMAN GREENSPAN. It's probably good for the farm incomes of our wheat growers when they produce a crop, but it isn't good for manufacturers of combines! President Stern.

MR. STERN. Thank you. Mike, one of the themes that came through in the Greenbook, and you alluded to it briefly today, is the deterioration in inflationary expectations. You seem to think that inflationary expectations are going to rise, and I would like you to elaborate a little on that. It seems to me that one could tell a story that a lot of what is happening here stems from one-time supply shocks, and it is not obvious to me how that translates into inflationary expectations. So, I would like to know a little more about your thinking. Do you have some sort of COLA mechanism in mind or exactly what?

MR. PRELL. I think that's important whether it's a formal COLA--and COLAs are much less important in the economy today than they once were--or an informal process, in the sense that employers are conscious of what is happening to the cost of living and have some sort of behavioral norms for adjusting wages in light of changes in the cost of living. In any event, there would seem to be a tendency for one-time shocks to be built into wage increases as they engender a certain elevation of expectations about ongoing price increases. I think there is little basis for thinking that people will look at this price increase as a one-time shock, that workers will absorb that increase, pass the income willingly on to the farmers, and we won't have any resulting elevation of wage increases with resulting cost pressures. To date we don't have a lot of evidence to support this hypothesis, but if one looks at the Michigan survey for early May, coming as it does on the heels of the April survey, the one-year, mean inflation expectations measure has gone up fairly substantially and it seems quite likely that it has been affected by the gasoline price increase. We think that increase will be reversed fairly quickly, but as we move out into the second half of 1996, we are going to have, in our forecast at least, food prices increasing more rapidly and we would anticipate that the consumer will be quite sensitive to that change.

MR. STERN. So it is a sort of preservation of real wages story?

MR. PRELL. That's the most direct driving force.

MR. STERN. I gather that you think it's consistent with historical experience; we have had these kinds of shocks before.

MR. PRELL. As best one can judge, yes.

CHAIRMAN GREENSPAN. President Moskow, I'm sorry, I interrupted you. Did you have a follow-up?

MR. MOSKOW. I just wanted to make sure that the econometric model did take into consideration the reduction in the percentage of processed food costs that is accounted for by grain costs.

MR. STOCKTON. The model estimated with data from 20 years ago showed a 30 percent farm value in the CPI for food prices. That value is about 17 percent now, so we have made some allowance in the model's coefficients for the decline in the weight of farm grain prices.

MR. MOSKOW. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mike, turning from this supply shock to the underlying demand, you did mention a number of factors that you put into your projections that acted to damp demand. I was struck by how stable unemployment stays through 1997, granted that you are projecting growth that is a little higher than in 1995. Could you talk a little more about the unemployment and labor market side?

MR. PRELL. I take it that you are suggesting that we take as given the projected output path and look beyond that. The year 1995 is still something of a mystery. We had essentially stable unemployment in the face of very low GDP growth. One possibility is that GDP growth was mismeasured. One hint that we have, and have mentioned previously, is that looking at the addition from the income side one would conclude that GDP should have grown about a percentage point faster. That would help to reconcile this behavior. I don't want to push that too far. We don't know where the truth is in that regard, but it is a possibility. Another point is that these relationships are not super tight in the short run. There is considerable variability in the Okun's law relationship. This means that what happened last year could be viewed as just a random event or we could have some continued disturbance as we go forward. Last year, we had very weak growth in the labor force. We also had very small increases in household employment. These tend to correlate, but perhaps it is arguable that somehow or other we will get some rebound in the growth of the labor force and unemployment will tick up a bit and average out in line with the experience in earlier years. But there is nothing to suggest that we ought to think about it that way, and going forward, we have the labor force tending to grow slowly with a flat labor force participation rate. That is one uncertainty that we discussed previously, but basically we have a normal alignment of output growth and unemployment movements in our forecast.

MS. MINEHAN. Maybe it's just the tone of the Greenbook, but given the feel of the underlying strength of demand in the Greenbook I was surprised to see this stability.

MR. PRELL. I think that brings you back then to the question of whether demand really will slacken as quickly and as much as we have in the forecast. I indicated that a number of assumptions about the behavior of various sectors underlie that forecast. These really have not changed in our view. Our basic view has been that we don't see underlying forces in monetary policy, fiscal policy, the dollar, and so on that ought to be expected to produce persistently more rapid or slower growth than potential as we move out. In the very short run, we can see a flattening of motor vehicle production. The arithmetic relating to that helps us to reduce growth very quickly in our forecast from a more rapid pace in the second quarter to a moderate pace in the third quarter. We don't see ongoing, double-digit growth in business fixed investment as plausible, but we recognize some upside risk on the computer side. On the consumer side, we could now be seeing the wealth effects that were not perceptible earlier, and if that continued in some significant magnitude our consumption forecast might have an upside risk. In housing, the anecdotal indicators and recent survey evidence do not suggest that we are getting the kind of weakening in starts that we have in our forecast, but we are anticipating that there will be a significant drop, maybe fairly quickly. So, we can see these upside risks. Perhaps there are risks on the downside as well, but I take your point, and I think that I communicated the view that the risk seems at least as great on the upside at this point.

CHAIRMAN GREENSPAN. I think we should emphasize what you said, Mike, only if the relationship between the unemployment rate and the potential rate of operations of the economy as a whole were very tight. The data show that that is not the case. That's because the measurement problems that we have in all these statistics are fairly large and even if we had an exact or very tight relationship the data are going to be wrong. So, we have to try to average through the fog, and I think the latter is a little more dense than it used to be.

MR. PRELL. We recognize that, because we have a new current population survey that has been in place for only a short time, the short-run movements are very difficult to assess. The seasonal factors could have changed, and we don't have enough evidence on what they are doing. So, we need to take these numbers with a grain of salt.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. You mentioned that GDP on the income side was almost a full percent higher. Where do you suppose the big surprise comes from?

MR. PRELL. Well, I can't say that there is a surprise that I can point to. I suppose that relative to our forecast one thing that happened last year was that we got a lot of growth in profits. We don't see that as out of line with corporate profit reports, but, certainly, as things evolved last year that was one factor that was a surprise. Basically, we have had a significant swing in statistical discrepancies, and where that gets reduced, whether it's on the product side or the income side, one can't know. Historically, I think you find it somewhere in-between and a little more toward the income side on average.

MR. LINDSEY. I was thinking about the report on the Treasury balances that was mentioned earlier and why those balances are higher. Back in the old days, I would have said that the reason is the realization of capital gains because that doesn't show up on the income side. So you are saying that there is something else.

MR. PRELL. That is something that might be noted about our forecast. In essence, disposable income is currently being reduced by the capital gains taxes that we think are probably a significant factor in the heavy tax revenues, and yet that does not show up in income.

CHAIRMAN GREENSPAN. What it may suggest is that manufacturers appear to keep their books internally consistent on the income and the product sides. When we look at services, however, what we see are very considerable anomalies: a fairly small increase in productivity and reasonably slow nominal output growth, but a significant increase in profitability and therefore implicitly an appreciable rise in margins. The notion that has evolved here is that, somehow or other, either significant nominal GDP is missing from the nonmanufacturing area or, because of the productivity data, price levels are exaggerated, as indeed they almost surely are. One sees, for example, that over a protracted period the price of medical services in the CPI has gone up much faster than average hourly earnings and I suspect, though I haven't seen the data, much faster than the ECI for medical services. This suggests that real income has fallen dramatically in that area. I shouldn't say that; it's not real income which suggests that; it's the relationship between productivity and price or some wage-price that does not seem to be squaring at all. There seems to be a major anomaly in the structure of the GDP which for the first time may be on the income side. Perhaps with additional data five years from now we will have a more accurate appraisal of what has been going on. Ted just nodded this way! [Laughter]

VICE CHAIRMAN MCDONOUGH. Mr. Truman expresses his opinion perfectly; he does it with a nod.

CHAIRMAN GREENSPAN. I can measure his approval rating in the arc of his nod! [Laughter] Any further questions?

VICE CHAIRMAN MCDONOUGH. This may be related to the line of thunderstorms coming from the west and everyone wanting to get out of here.

CHAIRMAN GREENSPAN. If you had said that at the beginning, I would not have filibustered as much as I did. Who would like to start the Committee's discussion? President Parry.

MR. PARRY. Mr. Chairman, our monthly indicators model suggests that economic growth in the current quarter should be close to that in the first. We believe that this relatively high growth rate is temporary because it reflects the building of inventories by business firms. Thus, we see the economy slowing toward its long-run growth trend of 2 percent in the second half of the year, assuming that interest rates remain near current levels. We expect 2 percent growth in 1997 as well, which is just slightly below the Greenbook forecast.

Such a forecast is not as attractive as it might appear at first glance. The problem is that with the economy operating around full employment, it will be difficult to make any progress in getting the inflation rate down. In fact, our structural model suggests that there will be a small amount of upward pressure on inflation over this period, and of course that is what the Greenbook says as well. I find this forecast alarming and would like to be in a situation where the inflation rate is projected to come down gradually.

Moreover, it seems to me that the downside risks we were worried about earlier in the year have dissipated and that the risks are largely on the upside now. Economic growth could easily come in above our forecast. For instance, our structural model predicts a slowdown in the second half of the year, in part because of the recent rise in long-term interest rates. However, given that the market's expectation of future economic activity is embedded in long rates, it may be more appropriate to treat the recent rise in rates as an indication of a future robust economy. Since we are already operating at a high level of resource utilization, growth above trend even for a few quarters could present an upside inflation risk.

Turning to the region, economic expansion in the Twelfth District is continuing at the solid pace that was established in 1995, which remains more rapid than that for the rest of the nation. California is making a significant contribution to District expansion. While current employment statistics indicate that annualized job growth in California during the first four months of 1996 was below the 1995 pace, the recent statistics are likely to be revised upward. Other recent indicators such as a declining unemployment rate, substantial gains in state tax revenues, and reduced outmigration suggest greater underlying strength in the state economy.

After a relatively slow 1995, the Washington State economy expanded sharply in February and March, with noticeable job gains in all major sectors. Rapid expansion continues in Nevada, Utah, Oregon, and Arizona, with Arizona accelerating since November after slowing in the middle of 1995. Alaska and Hawaii remain somewhat weak, however.

Expansion in District employment continues to be particularly strong in the construction, services, and trade sectors. The growth of construction and real estate loans has been strong in the District, and planned construction remains high in several states. Growth in the District's boom states is still being spurred by expansion in manufacturing employment, and with a shift to higher-paid jobs, average manufacturing wages have risen substantially in several states. Consistent with the recent slowdown in the semiconductor industry, employment growth in the District computer and electronics sector slowed in the first quarter. However, our industry contacts believe that the semiconductor industry is experiencing only a temporary glut and that the computer industry will undergo rapid expansion in the remainder of 1996, although at a somewhat less robust pace than in 1995. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the available information on the Seventh District economy is consistent with moderate growth in the region. In general, manufacturing is still our strongest-performing sector with growth somewhat faster than the national average. Housing and retail sales have continued to perform reasonably well despite higher mortgage interest rates and inclement weather. Labor markets remain tight with few signs of significant upward pressure on wage rates. Our purchasing managers' surveys around the District all signal expanding output in April. Durable goods producers generally are less concerned than they were earlier in 1996, although they still expect growth to slow in the second half of this year. The Big Three automakers have raised their 1996 light vehicle sales forecasts slightly. They also have raised their second-quarter production schedules, mostly to build inventories but also to support slightly stronger-than-expected sales arising from the incentives that they have in place. Gross orders for heavy duty trucks in March were strong enough so that some producers have delayed their decisions on major cutbacks to "build plans" that had been expected in the first quarter. The cutbacks have now been delayed until the scheduled summer plant closings. Several other industries reported doing better than they expected earlier this year including producers of machine tools, appliances, and small construction equipment. Retailers generally indicate that sales in the District rose moderately in April and early May, although inclement weather this spring slowed sales of some seasonal items, such as lawn and garden merchandise and motor boats. Housing activity still appears to be fairly strong in most parts of our District. Sales of new and existing homes increased in March, housing starts and permits were up again in April, and recent surveys showed Midwest home builders to be the most optimistic of any in the nation in both April and May. District respondents to the senior loan officer survey reported strong increases in mortgage loan demand over the past three months.

Labor markets remain tight throughout the District. In fact, economic growth in parts of the District, such as Indiana, is reportedly being restrained currently by labor shortages. The unemployment rate in District states is more than a full percentage point below the national average. In March, total payrolls increased slightly more rapidly in the District than in the rest of the nation despite the relatively larger drop in manufacturing employment related to the GM strike. These workers, of course, are back on the payroll now. Despite the tight labor markets, we still have few reports of mounting wage pressures. In fact, over the past year, total employment costs increased less in the Midwest than nationally. Job security concerns are identified as the key issue that will be emphasized in the upcoming labor negotiations. In the steel industry, however, management is now offering a wage increase of about 5 percent over the next three years, while labor unions are asking about 7-1/2 percent. Either increase would be the most significant that these unions have had in 10 years but would still average under 2-1/2 percent annually. The current labor contract has a no-strike clause with binding arbitration so that the negotiations will be settled without a strike. I spoke with a CEO of one steel company. He said that he could clearly offset such wage increases with productivity gains.

Turning to the agricultural sector, the major story for us has been the surge in grain prices that others have mentioned. These higher prices have led to some scaling back in livestock and poultry production. With respect to the spring planting season, which is so important, cool temperatures and wet conditions slowed progress considerably in Indiana, Michigan, and Wisconsin, with Illinois close to average and Iowa well ahead of normal. It is still too early for us to know how much food prices will rise. That will depend largely on whether the harvest eases or exacerbates the critically tight grain supplies. On the other hand, the higher grain prices have accelerated the uptrend in land values and have strengthened the balance sheets of many farmers in our District.

More generally, however, most reports still seem to point to little upward pressure on prices. Contacts indicate that price increases remain in check both on the input side and the output side. Auto industry suppliers report significant pressures to cut prices, and long-term purchase contracts for steel are now renegotiated with smaller price increases. However, price components in both the Chicago and Detroit purchasing managers surveys did move from signaling a decline in prices of parts in March to an increase in April.

Turning to the national picture, we are in general agreement with the Greenbook. The outlook is for growth at or above potential for the remainder of this year. The key issue, of course, is the outlook for inflation. The Greenbook projects that energy and food price increases are likely to push the CPI up a little faster than we would like. At the same time, the extent to which the underlying rate of inflation is inching up is still unclear. Certainly, the risks of higher inflation are greater today than at the time of our last meeting, and this is a matter of concern.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. On balance, the Eleventh District economy has been experiencing moderate growth and the near-term prospects look reasonably good. Employment growth in the first quarter was about the same as nationally, but growth accelerated throughout the quarter. Real estate and construction have tended to be among the strongest segments of the District economy. Single-family construction is doing particularly well, with levels of starts and new permits in a few of our cities reaching levels not seen in about a decade. Although this is still the exception, leasing activity in a few of our hotter commercial and office markets is being limited by a shortage of supply for the first time in about 15 years. Manufacturing activity remains strong overall, corrugated box demand is on the rise, and we have seen shortages and rationing of cement. Even in the semiconductor industry, where inventory has been growing and prices that had been falling are now flattening, the bad news is that output growth will slow dramatically from the rates of the last few years. The good news is that the semiconductor demand is likely to grow by only 10 percent in the year ahead. The oil price hike was temporary, and oil prices are now back to more sustainable levels. Whatever boost the Dallas District gained from higher energy prices is behind us, and the industry is back on a long-term downtrend.

While I have just emphasized areas of strength, there are two negatives that are worth mentioning. First, the impact of drought conditions in much of our District has spread from hearing complaints from ranchers to hearing complaints also from farmers. Beef cattle prices are at a 20-year low. Grain prices are high, but District farmers have lost much of their crop and cotton producers are getting hurt as well. Our agricultural bankers are reporting rising debt loads and delinquent payments. The second cloud on the horizon is the prospect of an increase in the minimum wage to $5.15. The data from the establishment survey of wage and salary employment indicate that nearly one-fourth of Eleventh District employment consists of workers earning less than the proposed minimum wage, compared to about one-sixth in the nation as a whole. Using the household survey narrows the gap considerably. Either way, the Eleventh District states would bear a disproportionate burden of the negative employment impact of higher minimum wages.

On the national economy, I am encouraged by the signs of strength, although the uptick in inflationary pressures, while having a number of transitory components, has worsened the inflation outlook. On the other hand, bond and foreign exchange markets have already tightened and will be countering inflationary pressures as we go forward.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, economic conditions in New England are quite favorable, though many of our business contacts describe the situation as continuing to be highly competitive and tough. Employment grew at a rate of about 1-1/2 percent last year and in the first quarter of 1996, slightly less than the pace for the nation but consistent with New England's long-term experience. The regional unemployment rate was 4.7 percent in April, with New Hampshire and Vermont enjoying rates below 4 percent. We do not think that this is an indicator that wages are about to take off in the First District, however, since in growth periods New England typically has an unemployment rate below the nation's. Our contacts with regional businesses are generally reassuring on this score. Wage increases of 2 to 3 percent are the norm, although a few companies are going to be more generous. Anecdotally, we continue to hear stories of severe labor shortages, mostly for software specialists. At the Bank, we have been trying to hire data communications people, for example. It is not just a question of money. These specialists would rather work for a consultant, or even as temporary employees, to get flexibility and to ensure that their skills stay on the cutting edge. Materials and vendor prices are flat, and retailers are holding the line on customer prices. A few manufacturers have succeeded, however, in raising their prices by modest amounts.

The retail situation in New England is very competitive, making it difficult to discern underlying economic trends. Upscale stores are doing well, but discounters are struggling. Their sales are down from a year ago. Among manufacturers, revenues are continuing to grow at a fairly good rate. Business is especially good for manufacturers of capital goods, particularly those producing traditional products such as industrial machinery and equipment used in construction and high-tech companies producing computer networking and microelectronics products. Concern was expressed about signs of slowing in the semiconductor business, as others have mentioned, although the correction is expected to be temporary. In addition, several of our manufacturing contacts think their inventories are a bit on the high side despite generally good sales. Retail contacts in contrast believe that they have their inventories under control.

Loan growth in the First District continues to be slower than for the nation as a whole, and our banking contacts report that the competition to make loans is fierce. Banks indicate that they are not lowering standards so much as they are relaxing terms--for example, by not requiring personal guarantees. I question whether terms and standards really overlap and how one can distinguish between the two. I think this is an issue for some of the lending officer reports that we get.

On the national scene, I remain convinced that the risks have tilted substantially to the up side. As the Greenbook points out rather forcefully, sources of economic weakness and potential restraints on the fairly solid pattern of current economic growth seem few. On the other hand, threats to the rather benign run of price data that we have experienced seem significant. I believe these may stem more from inherent demand than from supply shocks in food and energy. Those shocks could be short-lived and flow through only to a moderate extent to the general price level. However, the impetus from tight labor markets, continued income growth, consumer durable spending, business investment, housing, and the stock market rally could be considerable. The issue for me now is not the direction of the next move but when we make it.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, the Southeast has continued to grow moderately this spring, led by strong and broad-based activity in two of our states, Georgia and Florida, where over half of our District's income is generated. Employment growth in the District has been at a rate of almost 3 percent so far in 1996, nearly double the national average. But, of course, we were spared the bad weather and the GM strike that affected other parts of the country earlier in the year. The fastest income growth has been in Georgia, Florida, and Tennessee.

With this good income growth has come excellent, although somewhat uneven, consumer spending. There has been particularly noticeable strength in home-related goods like furniture, appliances, and carpets, and noticeably weak apparel sales. Housing activity has remained generally good for longer than we expected. In fact, there are reports of shortages in inventories of single-family houses in Nashville and Birmingham. Multifamily building is still growing at a rapid pace. Construction of commercial buildings apparently has accelerated throughout the District, but we don't see worrisome speculative kinds of building in that sector of the construction industry.

Manufacturing activity in our region has picked up some in the last few months, but the outlook has softened a bit despite increased orders for production. Wage and salary pressures remain about unchanged. Recently, employers have been more concerned about possible wage pressures, but at the same time we see or hear no substantial evidence that actual labor costs are accelerating. In fact, I have just completed a round of meetings with small groups of business leaders in various cities in our District. One story that I believe got told by someone in each meeting, with expressions of agreement from other people at the meetings in almost every case, was how difficult it is to push through price increases in contrast to their past experience. Someone described the situation at one of those meetings last week as one where almost every customer was acting like Wal-Mart or Home Depot in saying to their suppliers, here is what I will pay; don't tell me about prices.

Finally, there is some good news from our Louisiana oil patch, which has been through some really tough times over the last few years. Drilling activity has picked up moderately. The improvement is not so much in response to recent world price increases but rather is attributable to some new technology for three-dimensional seismic testing, which makes it easier to pick the places to drill, and to deeper drilling capabilities than were available in the past.

With regard to the national outlook, while I would not dismiss the role that special events have played so far in 1996, I would continue to argue that it is important to focus on those influences that will prevail beyond the next few months. In doing that, our outlook is not much changed since late 1995. We are now forecasting GDP growth of about 2-1/4 percent. We anticipate that the somewhat stronger-than-expected growth in the first half of the year will be damped in the coming months by the higher long-term interest rates that we have already seen, a slowdown in housing and related spending, some deterioration in consumer balance sheets, and the persisting uneasiness among workers that people have talked about for a long time.

We now expect the CPI to average about 3 percent for the year. That is about 1/4 percentage point above our forecast of a few months ago and reflects all that we now know about oil and grain prices. We expect the impact of higher oil and food prices to be moderate in the near term and to dissipate by later next year. In particular, the oil price increase was comparatively modest and should be reversed rather quickly. I think it is very unlikely that the price changes that we have seen will become embedded in expectations and general price-setting behavior without some decision on our part to accommodate it. If I am confident of anything this morning, it is that we will not do that.

Our forecast of economic growth into next year differs at the margin from that in the Greenbook, but the differences are not substantial. Those differences are somewhat greater near the end of the forecast horizon where we see a bit slower growth and the inflation rate coming down somewhat more quickly. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District economy continues to grow at a strong pace with most indicators pointing to little change since our last meeting. Recent employment reports show that the number of jobs in the District grew again in March and that employment in all seven of our states is growing at rates above the national average. Manufacturing and retail trade remain principal sources of strength in our region. Our survey of factories throughout the region indicates a recent rebound in production schedules and optimism about the next six months. In addition, building activity is running above a year ago and our directors report continued strength in commercial construction. The recent runup in oil prices and a more favorable outlook have boosted energy activity in the District. Drilling activity, for example, has shown steady increases over the last three to four months, and energy employment actually rose in March, the first increase in recent memory.

While economic activity is generally solid in our District, the agricultural sector remains weak, and the District's very important cattle industry is mired in a deep slump. The liquidation of cattle herds appears to have begun. One of our large packers said that their average slaughter rates are up 12 to 14 percent a month over three months ago. Although our wheat crop is now expected to come in at about half its normal size, the rains that we have received point to a more favorable outlook for other crops, corn for example.

Price pressures are still stable, but I do want to share some anecdotal information. I am aware that the plural of "anecdote" is not "data!" With regard to the labor markets, our discussions suggest that highly skilled workers are getting some fairly good wage increases. That would include Boeing-type employment in Wichita. Those increases are having a ripple effect and are causing some gains down to the bottom end of the pay scale--such as increases to $6.00 an hour for entry-level clerks. In the crafts area, business agents for workers in our area tell us that they have not seen such strong demand for their workers since the late 1960s and that their ability to negotiate favorable wage settlements has improved dramatically. So, we are seeing some increasing anecdotal evidence that suggests rising wage pressures going forward.

On the national level, our forecast is in line with that of the Greenbook. In the very near term, we continue to see growth at a rate above that of the first quarter. With the long-term interest rate increases that have occurred, we anticipate that the rate of expansion will fall back toward the economy's long-term growth potential later in the year. With regard to inflation, I am less optimistic than the Greenbook and increasingly concerned about the upside risk of greater inflation. While current inflation does reflect the effects of supply shocks, I, like others around the table, believe that the economy is operating fundamentally at a level where the unemployment rate is around its potential and capacity utilization around its potential. Accordingly, I see the upside risks of inflation as noticeably higher, and we should take that into account.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. Economic activity in the Philadelphia region is showing signs of improvement across a wide range of sectors including manufacturing, retailing, and construction. Growth is uneven across the District, however, and overall the region lags the rest of the country. I would still categorize the overall growth rate as probably modest. Some areas in the District have low unemployment rates while others still have quite high levels of unemployment. Wage pressures, while firming in a few areas, generally are not accelerating. General price inflation also is still subdued, but some commodities like metals, fuels, agricultural commodities, and textiles show some firming tendencies.

The national economy appears to me to be in reasonably good shape. I think the downside risk of late last year and early this year has subsided. While we see clear signs of firming in the national economy, I really do not see a high probability of a break-out on the up side. The outlook for moderate growth is therefore well founded in my judgment. Developments on the inflation front clearly need to be watched going forward. The economy does seem to be somewhat less inflation-prone than in recent decades, witness the experience since 1994 where we have had an unemployment rate of 5-1/2 percent and the inflation rate has stayed more or less constant. To what extent and for how long this favorable experience will last we don't know, so we have to be cautious about what we say concerning the future. We are, however, better positioned now than we were in 1994 to deal with inflationary pressures, should they arise. Then, we had a clearly stimulative monetary policy and a considerable distance to go just to get to a neutral policy stance. Today, we certainly are closer to a restrictive policy stance, should we need to get there, so we have more time to engage in watchful waiting.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Thank you, Mr. Chairman. At the District level, the overall picture has not changed a lot since our last meeting. Our regional economy is still growing at a moderate to moderate-plus pace, and I would say that growth is occurring pretty uniformly throughout the District. Also, increasingly we see signs that the level of activity is high in relation to capacity levels. In particular, several of our directors and other business contacts have told us about shortages of skilled labor. We were getting some reports like this earlier in the year, but they are continuous now, especially with respect to skilled construction labor. In that regard, we see considerable strength in both residential and commercial construction across much of the District, notably in commercial construction along the lines of Bob McTeer's comments. I think a lot of the excess commercial space including office space, which was so apparent earlier in the expansion especially in the northern part of our region, has now been absorbed. Vacancy rates in Richmond, for example, are very low in a variety of categories of commercial space. The same seems to be true in at least some parts of the Washington metropolitan area for the first time in a long time. We are getting some reports of speculative construction, which we have not heard for a long time. One other regional report that might be worth noting is that corporate recruiting at the three major universities in North Carolina--UNC, Duke, and North Carolina State--was up about 20 percent this year. I guess this is consistent with the view that economic activity in our region is reasonably firm.

At the national level, let me first tell Mike Prell that I like the change in the format of the Greenbook. I think it was a good product before and the changes make it an even better one. But the content of this month's reported projection worries me a good bit. The Greenbook paints a picture--and I think a generally accurate picture--of an economy that is in a mature stage of a business expansion and growing at a firm pace in the neighborhood of capacity levels with all of the inflationary risk that that entails. Let me make just a couple of comments on this. First, it seems clear as a number of people have already suggested that aggregate final demand is considerably stronger currently than one might have anticipated a few months ago. The first-quarter GDP report was very revealing. It showed remarkable strength across the board, and I think that was really the key feature. Second, the numbers Cathy Minehan, Bob Parry, and a number of other people have already mentioned permit a very strong case to be made now that the risks in the outlook have shifted decidedly to the upside for both real growth and inflation. The Greenbook is now projecting 3-1/2 percent real GDP growth in the current quarter. About a percentage point of that, as I understand it, would be in productivity growth and about 2-1/2 percent in an increase in hours worked, which is well above a sustainable noninflationary pace. Moreover, the stronger projected growth in GDP this quarter is predicated primarily on stronger inventory investment. The projection for growth in final demand actually shows a deceleration from the first quarter. If that does not happen, the current quarter could turn out to be very robust, with the implication of increasing tightness in an already tight labor market situation. In addition, there are the current problems that have already been mentioned with respect to prospective energy and food prices and the possibility of an increase in the minimum wage.

I think any one of these problems could be managed, but when they are all put together, that raises some real questions about the outlook. The Greenbook scenario to a large extent is counting on the runup in long-term interest rates to moderate the growth in final demand as we move into the second half of the year. The basis for this, as I understand it, is that real long-term rates are being driven up by the cyclical strength in the economy. By pushing real long rates up, market forces can in that way be counted on to contain demand and bring it back to trend. What worries me is that the discussion in the Greenbook gives the impression, maybe not intentionally, that all of this can happen without an increase in short-term rates. But as the first chart in the Bluebook makes clear, the backup in long-term rates seems at this stage to be due to a rise in 1-year forward rates concentrated maybe 1 to 3 years out. In other words, it looks like a significant part of the increase in long-term rates has been driven by the expectation in markets that the Fed is going to raise short rates by at least a moderate amount either late this year or maybe early next year.

CHAIRMAN GREENSPAN. Isn't that more the result of a shift away from the expectation that they are going lower?

MR. BROADDUS. Certainly, it is partly that, but if you look at the--

CHAIRMAN GREENSPAN. If you look at the actual pattern of forward rates, going from overnight out to a couple of years, what happens is that if the long-term rate moves the way you said, the other rates move back up. According to the analysis in the Bluebook, it is difficult to determine whether the term structure at this stage is reflecting anything more than liquidity demand. So, isn't what is involved fundamentally an upward shift in the yield curve as distinct from a shift up in yields?

MR. BROADDUS. Well, I think both elements probably are involved. If you look at the first chart in the Bluebook, the middle panel there, I am trying to draw an inference from that. What it suggests to me at least is that expectations for short rates may be pretty flat through, say, the third quarter, but after that, if one looks at Treasury yield curves, I think they are showing an expectation of a tightening of policy late this year--

CHAIRMAN GREENSPAN. I agree with that. I am just saying that it is very difficult to differentiate the extent of the rise from what we think we know about the liquidity premium. It is probably right that it is slightly more than the latter, but the major shift has to be coming up from the bottom.

MR. BROADDUS. Well, I would certainly agree that it is always difficult to read the term structure and draw precise inferences from it. We tried to look at this pretty carefully, and as I look at the entire structure, it seems to suggest that general expectations--and I think this has been confirmed in some of the documentation--are that we are going to hold policy pretty steady at least through the third quarter and move after that. The only point I am trying to make is that the behavior of long rates--and in the overall scenario long rates are a major factor in containing demand in the future--may be more closely related to policy expectations than to fundamental economic conditions. If that is the case, then it follows that we can't be sure whether the increase in bond rates that has occurred will necessarily contain demand and inflationary pressures to the degree that we want.

CHAIRMAN GREENSPAN. That is an interesting hypothesis, but I think you would have a tough time debating it.

MR. BROADDUS. I have a tough time in all debates, but I would still be willing to debate this! [Laughter] In any case, I think it raises some questions about whether holding short-term rates relatively constant over the remainder of the year is going to get us where we need to go, or whether we need to consider something stronger.

CHAIRMAN GREENSPAN. That is definite but that conclusion can arise independently of the yield curve! Let me say, parenthetically, that Don Kohn said to me the other day that these meetings were getting duller and duller and I was worried that he might fall asleep, so I tried to liven things up a bit. [Laughter]

MR. BROADDUS. I will try to help keep him awake as much as I can! [Laughter]

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. The pace of economic activity in the Eighth District appears to have increased modestly since our last meeting. For the three months ended in March, District labor markets remained tight. The average unemployment rate is below 5 percent, and it has been that low for a large part of the last year and a half. Strike activity, which had been quiescent, is again a factor that may impact costs at several large District manufacturing firms. On Sunday, a machinists' union at one of St. Louis's largest employers authorized a strike that will affect about 7,000 workers directly. The contract bargaining strategy in the auto industry is yet to be determined, but negotiations will be getting under way later this year. The two largest automotive producers in the District plan to boost second-quarter production by nearly 5 percent above their first-quarter levels. Second-quarter production is about 1 percentage point more than had been planned at the time of our March meeting.

Residential construction activity in the first quarter was at a relatively high level. By contrast, construction contracts point to some prospective weakness in the nonresidential sector, a pattern that despite strong overall capital spending is also observed in the national statistics. Loan growth at 11 large District banks has been off somewhat in recent months from the torrid pace of a year earlier. This year such loan growth has been dominated by real estate loans. Lenders are still very actively seeking borrowers in every category, including consumer borrowers despite some concerns about their creditworthiness. According to the senior loan officer survey, consumer loan delinquencies have picked up somewhat more than had been expected over the last six months. Nonetheless, the rate spread between securities backed by credit cards and comparable maturity Treasuries has remained very low.

The national economic outlook has changed dramatically since January, as we all know, with a rebound in real output growth and inflation. Imports also have increased substantially, a possible sign of excess growth in domestic demand. One can't dismiss the increase in inflation simply because it reflects mainly higher prices for food and energy. I think the Greenbook and comments from Mike Prell support that assessment as well. Low levels of agricultural stocks and rising demand for petroleum do not suggest an early reversal of such price pressures. Furthermore, the broad monetary aggregates have been growing above target rates and sweep-adjusted M1 growth has been strong. By pegging the funds rate at 5-1/4 percent in the face of rising market interest rates--here we are back in the same debate, I guess--we may effectively be validating these price increases. The danger is that if price increases are validated by monetary policy, they can become embedded in expectations, particularly in a tight labor market situation. On that front, the Greenbook reports that wages and salaries shot up at a 4.6 percent annual rate in the first quarter, the largest increase in 5 years. The increase in 1995 was 2.8 percent. Furthermore, according to the Michigan survey--and Mike mentioned this as well--households have raised their inflation expectations for the next 12 months from 4 percent in December to 4-1/2 percent in April to 5 percent in May. Looking over the next 5 to 10 years, average expected inflation in this survey is up from 4.1 percent in April to 4.8 percent in May. These forecasts can be wrong, but in any event the public perceives that inflation risks have increased about a full percentage point this year. That matches the increase in long rates since January. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you. In the Ninth District, while there was some pause in growth earlier, activity has once again picked up. Most of the news has been on the positive side, and I would say that the regional economy is now advancing more strongly than I, certainly, expected just a few months ago. To give you a flavor of some of this, housing activity is strong and as best I can judge will remain so. There is a lot of activity in major metropolitan areas and housing shortages in some parts of the District. Manufacturing activity is strong and improving; state tax revenues have been running above expectations; and energy exploration activity has picked up. Perhaps the one obvious sign of difficulty is in agriculture where some livestock producers are having severe problems and where grain producers say they may or may not harvest a crop. Our problem is not drought; it is too much ice and too much moisture. Farmers have been getting out into the fields late, among other problems.

As far as wage increases and price pressures are concerned, I would say there has been no pronounced change, but there are scattered indications that labor is getting a little more aggressive and wage increases in some instances are turning out to be a little higher than we were hearing earlier. On the price side, the anecdotal news does not indicate any pronounced change, but I sense that, if anything, there is perhaps a little more inflationary pressure than was the case just a few months ago.

With respect to the national economy, I certainly agree that there are increased risks of more inflation than I expected earlier. We are going to get more inflation than I anticipated. It is difficult for me to assess the degree and duration of these risks. It was not very many months ago that the concerns were focused more on the down side, appropriately in my view. That was the case in late 1995 and early this year. Those concerns have obviously diminished, and diminished rather quickly. I can imagine that some of the upside concerns prevailing at the moment could diminish quickly as well, but my sense is that it would take a favorable combination of events for that to happen as quickly as it did earlier on the down side.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. This is the first time that I have been the first of the governors to comment. This is amazing; maybe I'll master the timing of this process eventually!

I have been staying with the story of moderate growth for a number of meetings, and I am beginning to bore even myself. But I do think there is now a bit more certainty to such a forecast than there was earlier. A lot of the uncertainties that we saw in the fall have dissipated. Until I heard Mr. Melzer, I thought we were past the major strike activity problem, but maybe more strikes will be generated in the Midwest. By and large, however, some of the major strikes are behind us, and certainly the possibility of a Treasury default that was a prime concern for this group is now behind us. The question of government shutdowns and the issue of budget deals appear to be a bit more quiescent now. We did not get a long-term balanced budget agreement, but it does appear that progress is being made on a year-by-year basis in terms of holding expenditures down and addressing the near-term budget deficit. The winter weather disruptions are behind us and we are free to worry about summer drought, planting conditions, and heat problems.

The recent statistics display considerably more strength. The labor market is still showing reasonable job growth, and the 5.4 percent unemployment rate is impressive. People are working and they will continue to spend. Housing has remained amazingly strong because the fundamentals remain strong. Business capital spending has been a major factor in the continuing expansion and seems to be growing further in the context of an apparent commitment to capital expenditures to reduce operating costs. Computer expenditures appear to go on and on, and I do not see an end in sight, especially in light of the new opportunities stemming from the Internet. But I think the outlook for expenditures on plant expansion is much more questionable.

There are some factors favoring the sustainability of this expansion. Inventories are in much better balance now than at the end of 1995. The financial markets are continuing to support opportunities for additional investment. In spite of the backup in interest rates, the term structure is still reasonably low. The stock market is surprisingly strong, perhaps a bit on the rich side now, but it is still providing a cheap source of equity capital. Bank credit is still available. Balance sheets are healthier. As I mentioned, we have made some progress on the federal deficit. The question now, I believe, is what kinds of things can throw the economy off this sustainable growth path? In my view, unless we resume concentrating on deficit reduction and start to address some of the longer-term deficit problems--entitlements in particular--this issue is going to come back to haunt us and we will have higher inflation expectations and higher interest rates. We always have to question where we are with respect to aggregate demand. It has been stronger than we had expected, but there are some signs that suggest we should at least question the continuation of growth at the current rate.

On the inflation front--and this is where I want to end my comments--it is possible that the increases in energy and grain prices can be temporary. But if they are sustained, they will get built into other price structures and into the wage structure. We are getting differing anecdotal stories concerning wage pressures, but we are now seeing indications of some firming of wages in the statistics. An increase in the minimum wage, if there is one, would exacerbate the situation. I continue to be bothered by our concentration on the CPI as the appropriate measure of cost-of-living increases. I appreciated the inclusion of the GDP chain-weighted price index in the Greenbook, but it also has problems. Manufacturers report that they can't make price increases stick, and yet we are seeing some price increases. Weighing all of these differing reports and anecdotal stories, I think the inflation risk has increased and we need to be focusing on that.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Thank you, Mr. Chairman. I believe we may just now be entering a very tricky and important period. The Greenbook shows a very near-term deceleration in GDP growth to a 2 percent annual rate. Despite that, the staff foresees, as do many others here, an inflationary creep even without a minimum wage bill. If we get that bill, I think the rise in inflation might come sooner and become stronger. In my view, we have been riding the crest of a really remarkable period. Growth has been satisfactory. We have had an unemployment rate of around 5-1/2 percent, which of course is seen as being at or below the NAIRU, for well over six quarters now. GDP is at or near potential. In spite of that, inflation has remained quiescent. We certainly do not have the price level stability that we want to achieve, but inflation nevertheless has been flat and relatively low. So far, no significant trend is visible in the statistics. The Greenbook and other forecasters project some change in this starting very soon--in the third quarter--and going forward through the forecast period and beyond. We are all very jealous of the progress that we have made; we certainly want more; and we probably would see a persistent rise in inflation, even if it were a slow rise, as very dangerous. The question is whether it will happen and if so, when.

If we look at GDP growth in recent quarters and the Greenbook forecast for the upcoming quarters and include the 3.5 percent growth rate projected by the staff for the current quarter, we find that the average for this quarter and the previous three quarters is a growth rate of 2.5 percent. However, GDP growth has been accelerating over the last three quarters. If one looks at this quarter and the next three as projected in the Greenbook, they average a little more than 2.4 percent but display a slowing trend. That is the projection. The big downshift in GDP growth is expected to come in the period immediately ahead, in the third quarter, after which such growth is projected to flatten and stay around 2 percent. It seems to me that this outlook is quite credible, quite likely. It seems to be centered on sectors like housing, capital investment, net exports, and government expenditures. We have seen long rates rise; we have seen the dollar rise; we have seen the deficit go down, so this outlook is quite plausible. If we get that pattern, it seems to me that it is also plausible that inflation might continue being dormant. We may even find that the economy's potential is a bit higher, closer to the 2.4 percent or 2.5 percent growth that we have been experiencing and expect to experience on average. With such growth rates, inflation might remain benign, and that would be an extremely positive development. On the other hand, if the economy continues to be stronger than expected, as we have seen recently, and if it stays this strong much longer, we certainly could face a highly increasing likelihood of greater and perhaps somewhat more virulent inflation than is projected in the Greenbook.

I will close where I began. I think that we are possibly at a very important watershed. There are some very important months immediately ahead.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I would like to comment on two issues central to the national economic outlook: first, the possibility that aggregate demand growth will exceed trend over the forecast period, pushing the economy well beyond potential; and, second, the prospect that core inflation will begin to drift upward even if the economy continues to operate with current margins of slack. On the first issue, the Greenbook portrays an economy poised for growth near trend by the second half of 1996. In my assessment of the outlook, the risk of sustained demand growth exceeding the growth of potential is not absent. Frankly, I was surprised by the strength of both consumption and investment spending in the first quarter. Nevertheless, I still consider the Greenbook projection of moderate near-trend growth over the forecast horizon to be sensible and most probable. With the inventory adjustment process seemingly nearing completion, at least by the end of this quarter, I find it hard to identify any fundamental factor or imbalance--other than the dangerously lofty level of stock prices--that I consider likely to spur either unsustainably rapid growth or alternatively to pose a significant risk of recession. The stock market factor, it seems to me, could cut either way; it poses both kinds of risk. Why do I feel that way? For the same reasons the Greenbook emphasized. Pent-up demand for consumer durables seems to be spent. If we can continue to rely on what is one of the most trustworthy relations in macroeconomics, namely the accelerator, it seems probable to me that the growth of investment spending will slow. The combination of moderate growth in our key trading partners, coupled with a dollar that has appreciated about 4 percent just this year--the dollar's movement is working as a stabilizer, as Ted Truman emphasized--should contain impetus originating in the external sector.

In addition to the appreciation of the dollar, of course, the most potent force countering any spending shock that may have occurred is the large swing in financial conditions. Now, it is arguable that some portion of the roughly 80 basis point increase in long-term interest rates since late January reflects higher inflationary expectations. But my own reading of survey measures of inflation expectations suggests that most of the movement represents an increase in real rates. I think such an increase is perfectly consistent with the perception that demand is stronger than previously thought, that the shock to demand is not transitory, and that the Fed indeed will need to pursue tighter policies than had been anticipated earlier to keep inflation in check. It seems to me that given the usual lags, this interest rate swing should begin to exercise a restraining influence by the second half of the year. A rule of thumb I sometimes use is that a one basis point increase in the long rate cuts $0.6 billion off aggregate demand, which means that, say, a 70 basis point increase in real rates would chop $42 billion or 0.6 percent off GDP. This is sufficient to counter a rather sizable and permanent upward IS shock. So, I see the interest rate fluctuations that have occurred as serving as an important stabilizer. Under present conditions, it seems to me that the rebound in long-term rates is an appropriate antidote to increased upside risk. However--and here I certainly agree with the comment that the Chairman interjected in response to Al Broaddus's statement--it seems to me that the 6 percent long bond yield that we had in January was premised on the assumption that we would have several further cuts in the fed funds rate. I also would agree that the present level of roughly 7 percent in the long bond rate appears to be consistent with a funds rate that is expected to remain about where it is or, with some probability, to increase slightly during the remainder of the year.

I also want to spend a minute, if I may, commenting on the outlook for core inflation because I think the Greenbook inflation forecast is a little too pessimistic. Clearly, we have an economy operating at a level where we need to be nervous about rising inflation, even abstracting from supply side shocks. We can't dismiss the possibility that compensation growth will drift upward, raising core inflation and in turn inflationary expectations. This is a major risk. Obviously, we need to be vigilant in scrutinizing the data for signs of rising wages and salaries. We should be concerned if a pattern of faster wage and salary growth materializes, if that translates into faster compensation growth, and if in turn the faster compensation growth translates into more rapid core inflation. But the sentence I just uttered contained three "ifs."

First, we need to see a pattern of faster wage and salary growth. As a number of you pointed out, we have seen one disturbingly large reading on wages and salaries in the most recent employment cost index survey. But the upward movement there was mysteriously rapid for sales workers and one reading does not a trend make. The second "if" in my sentence concerned whether an increase in wage and salary growth will translate into faster compensation growth, and that is a big "if." At this point, the 12-month change in total compensation growth in the ECI has remained virtually unchanged at around 3 percent for five quarters. I would just remind you that standard economic theory suggests that both firms and workers going to the bargaining table ought to be concerned with and ought to be bargaining over total compensation, not wages and salaries alone. Assuming that both firms and workers recognize the tradeoff they face between benefits and take-home pay, slower benefits growth should be reflected in faster wage and salary growth. So, on its own, faster wage and salary growth is not cause for alarm. Now, I do not want to push this hypothesis too far because, although this is a reasonable possibility, it certainly is not the only possibility. I am simply urging caution and am warning against automatically assuming that the growth in these two components of compensation is unconnected and that they lead their own lives.

My final "if" concerned the relationship between faster compensation growth and product price inflation and whether we should automatically assume that the translation there will be one-for-one. The counter argument is that for the last several years product price increases have outstripped increases in unit labor costs and that has resulted in widening markups, unusually strong earnings growth, and a rise in the profit share. In that sense, core inflation is on the high side now, given compensation growth and productivity trends. The staff documented this situation and highlighted its implications in the January Chart Show. Widening profit margins are a development that should not be expected to continue indefinitely. Eventually, those margins are bound to stabilize or even to decline a bit. That could occur in a number of ways: with a decline in the inflation rate coupled with stable compensation growth or with an increase in the pace of compensation growth and stable inflation. I think the first possibility implies some downside risk to the inflation outlook, and I do not see that in the Greenbook forecast. The second possibility is that compensation growth is indeed poised to rise somewhat, bringing a halt to the continuing widening of profit margins. That could occur without any translation into higher core inflation. These are a bunch of "ifs." They are all imponderables and they are open questions that will only be answered with the benefit of hindsight.

CHAIRMAN GREENSPAN. Thank you. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Thank you, Mr. Chairman. The broad economic indicators suggest that the economy in the Second District grew at a moderate pace in recent weeks, which is an improvement. In March, payroll employment advanced at an annual rate of 2.2 percent in New York and 3.3 percent in our part of New Jersey. Vacancy rates for prime commercial office space continued to inch down in Manhattan and northern New Jersey, reflecting the improvement in office leasings. Contract awards for nonresidential construction, primarily additions to and alterations of commercial space, rose sharply in New York compared to year-ago levels. The gain in New York was offset slightly by a 1 percent decline in New Jersey. In April, retail sales tax collections rose robustly in New York and moderately in New Jersey on a 12-month basis, implying moderate to strong gains in retail sales. Similar 12-month gains were reported in April personal income tax collections. Inflation moderated. The April consumer price index for the New York/northeastern New Jersey region rose just 2.9 percent on a 12-month basis, following gains of 3 to 3-1/2 percent during the previous 4 months.

On the national level, our forecast is rather close to the Greenbook's. The differences are that we show less growth in 1997, and we are below the Board staff in our estimate of the CPI increase for 1996. On a Q4/Q4 basis, we have the CPI at 3 percent this year compared with the Greenbook's 3.4 percent. However, we agree on 3.2 percent in 1997.

Our Bank's forecasting record over recent years has been quite good, except that we were slow to recognize the wage restraint that is the main reason for continuing good inflation numbers. We, like all of you, are not certain how long that can or will continue. But I could have said that a year ago, and the restraint has in fact continued. People running businesses still seem to be reluctant to raise prices. When we talk to business people, they sound very alarmist about their industry or about the country or the world in general, but I find that they know very little about those subjects. All I am really interested in is what they are planning to do with their own businesses. When we ask them that question, we are told about very severe price restraint--the inability to pass on rising costs--and the need to rationalize their businesses. So, I do not see great risks of the real economy growing above trend. In fact, we have strong growth in the first half of this year, especially in the current quarter, and then growth drops slightly below trend in the second half of the year and in 1997. So, I see the risks as balanced by-and-large. Despite all that, my anxiety level regarding price trends has begun to gnaw. However, I consider the present stance of monetary policy to be just about right or so close to it that, to borrow a phrase from Ed Boehne, "watchful waiting" is appropriate. In fact, when he mentioned that, I remembered back about four decades to my days as an officer of the deck on a Navy ship where the possibility of a storm encouraged one to increase the state of alert. On the other hand, increasing the state of alert did not in turn increase the probability of the storm. [Laughter]

CHAIRMAN GREENSPAN. It might have stirred up a storm! President Jordan.

MR. JORDAN. The most noticeable change since the last meeting has been orange construction-site barrels sprouting all over the Great Lakes region. Infrastructure construction is in full swing. It was explained to me recently that Cleveland in particular has been benefiting greatly from such construction. That is because, while Atlanta has the Olympics, we have a Bicentennial Year with a former mayor who is now governor and wants to be Vice President. That does wonders for suburban infrastructure spending! The irony of prosperity is that everything is closed for renovation and repairs. [Laughter] What apparently are not going to be sprouting in the region are crops. In the last couple of weeks we have heard a lot of statements that are alarming. They are in sharp contrast with what we were being told in March and April by bankers and individuals directly active in farming --farmers, equipment suppliers, seed suppliers--that high grain prices caused by the drought in other areas would make this the best year for the agricultural economy in memory for farmers in our region. Now that our farmers have already sold in the futures markets the crops that they have not been able to plant, people think it will be the worst year for the agricultural economy in memory. I do not know how pervasive the problem is, but I was told that as of last Friday, only 6 percent of the corn crop was planted in Ohio. Farmers say that if they do not have the corn planted by mid-May, they will switch to beans or some other crops. I am not certain how reliable that deadline is.

CHAIRMAN GREENSPAN. It is already May 21!

MR. JORDAN. Well, people are saying that there will be no corn harvest in our area, but I am not so sure about that. Others are telling us that the Amish do not have any problem; their horses are not slowed down by the rain. The stories also are very negative regarding the nationwide wheat and corn crops, and that carries over to chickens, hogs, and ultimately beef. I am not sure what to make of it all. Our bankers say that they are worried; they have a lot of farmers who were just too enthusiastic about selling crops for forward delivery, and that will result in a financial problem later this summer.

I recently participated in a round of meetings with about 40 people on our joint boards of directors and our small business and bank advisory councils. One of the questions I asked them was whether they were more or less optimistic about the economy than they had been at the beginning of the year. Except for one software company, they were consistently more optimistic even though the almost universal belief was that there will be an extensive General Motors strike. The auto supply companies and others are saying that GM has no alternative but to endure a lengthy strike if that is needed to adjust their badly misaligned cost structure to everyone else's. With regard to the software industry, there has been an increasingly strident claim that its growth is a bubble, that there is a severe downside risk associated with overpaying for these firms, and that one of these days we will see a very sharp correction in that industry.

Let me comment on some of the discussions we have heard on national issues. What the income side is telling us about the national income accounts in the economy is an important issue. It may explain why sometimes when we listen to the regional reports based on anecdotal information, they sound like we have achieved the Lake "Woebegone" economy where everybody is performing above average. An example is the anecdotes that we hear about productivity. When we ask them, people consistently tell us that their productivity improvements are substantially higher than those in the national statistics. We have to be cautious about how we interpret those reports and how much confidence we can have in them.

The exchange earlier today, which Governor Yellen also referred to, between the Chairman and Al Broaddus involves an issue that we all ought to settle in our own minds. Early this year it was said that interest rates had dropped as much as they had on the expectation that the expansion not only was going to be weaker than had been anticipated earlier, but that the economy might even be moving toward a borderline recession. The subsequent runup in interest rates occurred because the economy turned out to be stronger than people thought it was going to be. But the runup in interest rates also implied that the expansion eventually would slow, which presumably would mean that interest rates would come down, which means the economy will then strengthen. As to what that says about policy, it is pretty clear that at the beginning of the year and at least until early February, intermediate-term rates out to 10 years at least were based on an expectation of further reductions in short-term interest rates. My own conclusion is that today's rates, about 6.60 percent on the 10-year maturity, are consistent with an unchanged level of the funds rate. They are not based on the expectation that the funds rate will go up but rather on a reversal of the prior expectation that it will go down. I think everybody should try to settle that issue in their own mind.

With regard to the economic outlook for the nation, surveys such as those on consumer sentiment or the Blue Chip don't do much for me. Early this year we saw a lot of stories about the severe winter weather--record snowfalls, low temperatures, and all the evidence that we are going into a new Ice Age. Last week we heard evidence that we are in a period of global warming! I hope our judgments about the economy are more soundly based than those stories about the weather.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I have not been here since the last meeting for all intents and purposes, so I don't really have anything to say about the U.S. economy. But I find this discussion very informative and useful. Where I have been, I must say, makes me appreciate coming home. It is very depressing to live and work in Washington because it makes one begin to think there must be something wrong with America. But when I go abroad I realize that this is the way it works everywhere; there is something wrong with the world. So, at least I feel relatively better.

For the first time in years I agree completely with Ted Truman on Japan, and I think that means, Ted, that we are both wrong! In Japan, I was very much struck by the fact that the recovery is under way. They are going to have a solid recovery this year. Solid growth probably will not be sustainable next year but is likely to slow somewhat. Some of their larger banks have begun tackling their banking problems. What was most encouraging in Japan was the end of denial. I thought they were very candid about what their problems were. That candor was reflected also in a question that they always asked me about our stock market. I was thinking very much about what just came up in Jerry's comments about the bubble in the software industry. If you watch the OTC, not the Dow, you begin to appreciate that a bubble might very well be forming. On one day last week when the OTC was recovering, all of the top 10 issues were up at least 9 points. There are IPOs that do not trade at 20 times earnings; they trade at 20 times sales. My suggestion for such a company would be to sell, put the money in 10-year notes, and it would be better off that way. This is the silly season. To be sure, our stock prices are not at Japanese levels, but who knows how much longer it will take. They are getting closer. In Japan, it was nice to have candid questions.

Bill McDonough and I were in Basle last week, and I was in France and Italy and Switzerland the week before. I think there has been a decline in candor and an increase in the sense of denial. It really is stunning to me how everyone who even thinks about the issue will say: You are right; what we are doing is not economically sensible, but it is politically necessary. If they follow that kind of policymaking long enough, I don't see how they are going to come out of it. They are going to be announcing more deficit reduction measures, mostly on the spending side. The French are going to be following up the cuts in spending they have already made with further cuts just to look credible. I think they will hit 3 percent of GDP. When you have the kind of marginal propensity to tax that those economies have, which is 50 percent or more, and you begin to have spending contractions, it is very hard to lower the deficit because the inevitability of G and Y and T make the math very, very difficult. They are chasing themselves down. There is also a remarkable sense of denial or willingness to deny the problems

This seems like a very implausible basis on which to run a democratic society for very long. I think it is a good example of the state of denial in France and Germany.

I do not share Ted's view that we are going to have a weak euro. I believe we probably are going to have a strong euro because I think the only thing that they will be valuing after convergence is credibility. I do think that they are going to have some credibility problems. In my view that means their policy will have to be tighter than tight to begin with. I think the path of convergence is going to lead to a downward spiral in Europe, and after they get there they are still going to be continuing with that sort of policy. So, I came away from Europe very, very depressed, from Japan mildly encouraged, but, gee, it is great to be in America!

CHAIRMAN GREENSPAN. Coffee is available. Shall we break?

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Is the question whether we respond to that forecast horizon issue now or at a later time?

MR. KOHN. Whenever. It would be nice to have a little discussion at this meeting. Whether you want to do it after you have discussed the near-term policy choices--

CHAIRMAN GREENSPAN. Why don't we do that? Why don't we complete the near-term policy discussion and then come back to that issue and conceivably continue to discuss it during the lunch period if that turns out to be necessary.

MR. KOHN. That's fine.

CHAIRMAN GREENSPAN. Any questions for Don? Clear as always. I think this is indeed a watershed period, as Governor Kelley mentioned. As I listened to the members' comments relating the current situation to the Greenbook forecast and the staff briefings, I came to a few conclusions that I hope characterize the substance of what we have been discussing. My impression is that if I fully believed the outlook in the Greenbook and indeed expected it to materialize as projected, I would feel that we ought to be tightening policy sooner rather than later. The basic reason is that I find the federal funds rate assumption in the Greenbook inconsistent with the staff outlook. So, the key question that I envisage is essentially whether the internal construction of the forecast as postulated by the Greenbook is consistent with the world that I believe is evolving and to which we must adjust.

Let me say, first, that I think the Greenbook is projecting relatively modest growth in real economic activity and that the risks to that projection are probably on the up side. I say that because the staff is projecting a fairly dramatic slowing in the growth of final demand, and one can scarcely conclude that the projected inventory investment is other than subdued. We have seen rather telling instances in the past when business firms have liquidated inventories to the point of some tightness. As they endeavored to restore some inventory balances, lead times immediately began to stretch out on deliveries and desired safety stocks started to expand. The result has been a fairly substantial acceleration in inventory investment that has fed back to the income side and created an economic growth rate that is substantially greater than that in the Greenbook forecast. Implicit in this Greenbook forecast of real GDP is a degree--I could say a new form--of inventory response in the economy that certainly is much more subdued than that experienced in 1994. In a certain sense, it is also a good deal more subdued than one would anticipate on the basis of historic cyclical patterns over much of the post World War II period and far more clearly before then.

The crucial issue at this stage is the evaluation of the real side of the economy. The real side is being bolstered, as best anyone can judge at this stage, by the wealth effect. Not that many months ago, everyone was sitting around, here and elsewhere, and wondering what elements in the GDP were going to strengthen and sustain the recovery. We could not find it in residential construction. We could not find it in capital investment. The consumer was dead. The government had gone out of business. And clearly the export side was not doing anything. We are now sitting here and wondering what is going to moderate this expansion. The change has occurred in only a few months and no one can tell me that the world changes that rapidly. What is happening, and one sees it best by looking at the S&P 500 which has been going straight up in the charts, is probably the result of a wealth effect. That effect is lagged sometimes; it is indeterminate. It is very difficult to judge, but one gets the sense that this is where some of the effect is probably stemming from. Obviously, in the capital goods area we are getting some evidence of lower capital costs. We are getting related evidence of increased margins. And it's hard to buy that anything other than the wealth effect is driving the consumer.

That gets us down to the question of how long all this will go on. The stock market as best I can judge is high; it's not that there is a bubble in there; I am not sure we would know a bubble if we saw it, at least in advance. But one surely can't argue that the underpinnings of the level of stock prices are all extremely positive. It's hard to believe that if any series of adverse developments were to occur, the market would not come down rather substantially and reverse the wealth effect. That probably would damp economic activity quite substantially. But at this stage I don't think we can make a reasonable judgment because we don't know, frankly, how the inventory situation is going to evolve. We don't know how the accelerator issue that Governor Yellen has raised is going to affect the capital goods markets. At this stage the physical side of the economy is as close to balance as one can imagine. Yet, to quote Mike Prell, "the smoking gun" is missing. We are seeing a very pronounced set of pressures that are superimposed on the pricing structure. Every time I get out in the business sector I get reports, as a number of you also have indicated you were getting, that no one can raise prices; at least that is the way our business contacts put it. And, indeed, if we look at the basic structure of industrial prices, the PPI, and the CPI, we just do not find any significant evidence of cumulative pressures. We have seen very little in the data that measure capacity strain. We have seen very little in the way of increased delays in deliveries since that very significant measure of pressures came down. Overtime is not building. What we are seeing is a significant increase in the rate of capacity expansion of close to 4 percent at an annual rate as previous major investment projects are brought on line and push up capacity.

The key to this outlook, as I see it, is not an evaluation of the physical side of the economy that appears in the Greenbook because I suspect that starting at midyear economic growth may well be on the low side of recent experience. The crucial question is the linkage to inflation. At this stage it is very difficult to take the existing structure of the NAIRUs, capacity limits, and the usual potential analysis that we do and square it in any measurable way with what we sense from anecdotal reports. I am not saying that one cannot go out and find pressures on entry-level and skilled wages, because we are getting wage increases of 3 percent. If we were not getting any of those pieces of anecdotal evidence, the number would be zero. There are wage increases going on and what we are not sure about is the outlook for unit labor costs. It's not clear to what extent we are getting the usual, conventional pressures.

I go back to the issue that I raised about a year ago, namely that we seem to have created a level of job insecurity that has overwhelmed the pressures to increase wages. As I made the argument back then, the state of technology is creating a degree or sense of job obsolescence and fear that apparently--I use the word "apparently" because we really don't know and won't know until we look at this in retrospect--has induced a tremendous shift away from increased wages and toward more job security. To be sure, the extraordinarily small number of strikes in 1995, a half-century low, is not going to be repeated in 1996, especially if workers at General Motors go back on strike. Even so, we are still seeing a very subdued pattern of union labor contract settlements, granted that unions are an increasingly smaller part of the private-sector workforce. We have not yet seen the "smoking gun." I think it is important for us to see some of this evidence before we can be sure that the translation from real growth into inflation is following the historical patterns as closely as is implicit in the Greenbook. The Greenbook may well be right and, indeed, to argue that it is not is potentially dangerous. We can lull ourselves into thinking that nirvana is here: Inflation has died; it has been buried; we don't need to worry about it; and we can go on our merry way. That is a recipe for disaster. Nonetheless, something different is happening that we do not fully understand, and I think it's important for us to make certain that we not see the "smoking gun." The trouble, unfortunately, is that in monetary policy the "smoking gun" means "we already shot the guy" and essentially that inflation is still running. But there is something not happening out there. We are not getting the usual pricing pressures; we do not see firms able to move prices up at these rates of operation and at these unemployment rates. Something is going on that we do not yet fully understand.

How one translates that into policy requires us to recognize an important factor, which Ed Boehne mentioned--namely that, unlike 1993 when our policy was very consciously stimulative to try to undo the credit crunch, real funds rates are not all that low at this stage. It is not easy to determine what price expectation variables we should apply to overnight rates, but of the 75 basis point decline in the nominal funds rate that we have engineered, I suspect that less than half of it represents a decline in the real funds rate. Indeed, depending on which measures we use, it can be significantly less than that. It is true, as Don mentioned, that the real funds rate is in the lower part of the range for the period 1979 to date, but we obviously are well above the average rate over a much longer period of time. Were that not the case, I think we would probably have to make some very key decisions very soon and do so before we have the evidence on how this watershed issue is turning out. I must say that I agree with Ed Boehne that the existing rate structure is reasonably high--probably somewhere near average, maybe slightly restrictive, maybe slightly easy; I don't think anyone really knows. We can afford to wait and indeed we should wait for a short while. We probably will have to make a judgment by July. It is conceivable that if the inventory accumulation moves faster than the Greenbook presupposes, we would have to move sooner. But my general view at this stage, and I raise it as a recommendation, is alternative "B," that is, to do nothing at this stage. I would prefer a symmetric directive, but that is a debatable issue and one can have differing views on this. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I would like to concentrate on the part of your presentation relating to what we don't know. It is clear that we don't fully understand what appear to be some new relationships in the economy affecting the connection between the real economy and the inflation rate. And because I think that the present stance of monetary policy is close to being correct, if not absolutely so, I feel that we have the luxury of waiting until our next meeting in early July and I believe we should wait. However, we should be careful not to assume--and your remarks did not assume, indeed quite to the contrary--that today's decision to wait until the next meeting has any implication that we will reach the same conclusion at that meeting. The next meeting will be a new ballgame. In my view, all we are discussing is whether to do something today or wait until the July meeting to consider what we should do. I very much believe that we should wait.

As regards symmetry and asymmetry, if the incoming data suggest that it would be appropriate for us to move before the next meeting, those data will be sufficiently dramatic that I am sure you would wish to have a conference call. But I don't see the need for an asymmetric directive because I think the probability that you would be highly likely or even fairly likely to take action between now and the next meeting is quite low. If we were to adopt an asymmetric directive at this meeting, then not move to implement it over the next 6 or 7 weeks and decide for good and sufficient reasons at the July meeting that a change in policy was not appropriate, I think that the minutes of this meeting to be released on the Friday following the July meeting would give a very strange and difficult to interpret message. I do not believe such a message would be in our best interest. So, I very much believe that we should take alternative "B," and I feel perhaps considerably more strongly than you do, Mr. Chairman, that symmetry is appropriate.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I was not very successful when I talked about this insurance policy concept before, but I am going to venture into that territory one more time and then probably leave it at that. In my view, we in effect took out an insurance policy in January. In retrospect we did not need it, and I think now is the time to cancel and avoid the premium. In my view, inflation and inflation expectations have increased. I think the stance of policy is neutral at best and, more likely, somewhat stimulative.

Accordingly, with such a policy stance, I think it is unlikely that we can contain inflation at the level where it has been over the last several years. In other words, we are likely to lose ground. We certainly are very unlikely to make any progress toward price stability. The risk of waiting is that the premium on this insurance policy is not a fixed premium. It will go up. If it turns out that monetary policy is perceived by markets to be out of position in the face of what is happening in the economy and particularly with respect to inflation, it is going to cost a lot more to reverse it later rather than sooner.

My preference would be somewhere between "B" and "C." I would increase the funds rate by 25 basis points and probably accompany that with an increase in the discount rate, although that is a separate matter, obviously.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, as it turns out I want to talk about insurance policies as well. I believe that it would be wise to tighten policy at this time. We cut the rate in January because an apparent moderation in growth was reducing inflationary pressures and because we wanted insurance against the risk that the economy might weaken further. Since then, the growth picture of the economy has brightened considerably. Growth in the first half of the year now appears to be exceeding the trend rate. Since the need to guard against a slow economy has evaporated, it makes sense to undo the January reduction in the funds rate. Indeed, it seems to me that the risk we now need to insure against is an increase in inflation. This view is supported by the forecasts of both our staff at the San Francisco Fed and the Greenbook. At a minimum, it is safe to say that there is little reason to expect inflation to show a downward trajectory at current levels of interest rates.

In my view, these two considerations support a 50 basis point increase in the funds rate. However, given that an increase in the rate would represent a change in the direction of policy and would be a big surprise to the market, it would seem prudent to me to go for a 25 basis point increase at this meeting. Thank you.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. I agree strongly with Tom Melzer and Bob Parry and I am sure that will not surprise anybody. I guess my views on policy at this stage are predicated on a couple of things, Mr. Chairman. First, the long-term goal is price stability. The staff is now projecting an increase in the inflation rate next year. I think it is a credible forecast and it means that inflation is moving in the wrong direction. Second, I know there are risks on both sides of this forecast; there always are. But it seems to me that what we heard around the table this morning suggests that the risk definitely has shifted, in my view at least, to the up side given the strength in demand, price shocks in the energy and food sectors, and a possible increase in the minimum wage.

Despite the apparent divergence in our views about interest rates earlier in the meeting, I think we would agree, and I think most observers would agree, that the markets are not expecting a very pronounced tightening of monetary policy, at least in the near-term future--over the next two or three months. I find that a little intriguing because, given all that is going on and the clear change in the tone of the economy, one might expect market participants to anticipate somewhat more aggressive policy moves. There may be several reasons for this. One explanation might be that market participants are expecting us to be somewhat more hesitant in this period of the political cycle. Partly because of this, and given the underlying inflation risks and the upside risks in the outlook for economic growth that I and others mentioned earlier, I think we should raise the funds rate today. I would prefer or recommend a 1/4 point increase. Even though it is a change in the direction of policy, it seems unlikely to me that an increase that modest would do any significant damage to real economic activity, although there would be some real cost. I think the increased credibility flowing from such an action would hold down inflationary expectations and maybe reduce the amount of the increase we would have to engineer later in the cycle to contain inflation.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I would prefer that we tighten now. I think we have consistently underestimated the strength of the economy over the last several months and earlier, going back to last fall. We are looking for the economy to continue to be strong. We are no longer talking about capping inflation. We are talking about seeing it creep up, or move up, and that is the wrong direction because we want positive economic growth over the longer term. In my view, we may be compromising the sustainability of the expansion if we allow inflation to get much higher than what we are now projecting. At a minimum, we should have an asymmetric directive toward tightness.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. I am going to continue the revolt of the nonvoters! [Laughter] As I indicated before, I think we clearly have moved from a period of balanced risks to risks on the up side. The risks of increasing rates of inflation seem significant both from supply shocks and from demand factors. It may be that rising long-term interest rates will act to damp activity sufficiently, but the ebullience of the stock market and the continuing strength of such indicators as housing and consumer spending suggest that credit and funding are both available and not overly costly. In my view, the issue now is how forward-looking monetary policy should be. I have argued, and I continue to believe, that the costs of being wrong on the up side and letting inflation get out of hand are greater than being wrong on the down side. We need to act before we see the "whites of the eyes" of inflation, as you have argued, Mr. Chairman. I am also worried now that moving later in the year might be more difficult for a number of reasons, and that moving later than that might require a more significant move than we would otherwise need. So, for me the questions are how much to do and when to do it. In that regard, I want to piggyback on the insurance argument. We did 25 basis points in January. We thought things were quite slow at that point. Hindsight now shows that they were not as slow as we thought. I would reverse the insurance policy. I would move the funds rate up 25 basis points, and I would do it now. At a minimum, I agree with President Hoenig that the directive should be asymmetric.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. As I think about the economy and how it is likely to perform from here, my suspicion is that housing still has some momentum that will carry it beyond the next quarter or two. That would also be my judgment about capital spending. As far as the consumer is concerned, I do not doubt the significance of the wealth effect, but we have had sustained gains in employment as well. So, I don't think that what is going on in that sector is entirely a wealth effect. That leads me not to be terribly concerned about the outlook for the real economy. It looks satisfactory, or maybe even better than satisfactory, to me going forward. Is this going to translate into the kind of inflation performance that is forecast in the Greenbook or something even worse? You have pointed out, Mr. Chairman, that we do not fully understand what is going on there, whether it is job insecurity or other things. I agree with that. I think it may only be with the benefit of some considerable hindsight that we will understand that fully.

From another perspective, if I look at real interest rates and the real federal funds rate and ask myself whether monetary policy is too stimulative or too restrictive or too whatever right now, my judgment is that it is not very far from where it ought to be. I do not have a strong conviction as to which direction it may be off. When I couple that consideration with what I believe about the real economy and what I think I know and do not know about inflation, that tells me that anything we do ought to be quite cautious. I just do not have the sense that I know enough with enough confidence right now to come out strongly on one side or the other. So, for this meeting I am prepared to stand pat. But I must say that I am getting increasingly concerned about the inflation situation. While we can always explain it away with special factors--grain prices or energy prices or whatever--it is always true that if we take out the most rapidly rising components we get something that we like better. I think we have to be very careful about pursuing that very far.

CHAIRMAN GREENSPAN. Symmetric or asymmetric?

MR. STERN. I prefer symmetry on philosophical grounds.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. I think that if people outside this room who pay close attention to these matters saw the Greenbook inflation forecast for this year and next year and heard some of the comments and concerns that people around this table have expressed about the inflation outlook, we would be sending a very bad message by not taking action today. So, fortunately, outsiders don't see or hear those things. [Laughter] If the minutes of this meeting, which will come out right after the next meeting, and comments that people make in the meantime convey the idea that we see a worsening of inflation and are not doing anything, I think that would provide a bad message. If that is what happens, then I am going to regret that we did not take action. If I believed the Greenbook inflation forecast, I would have to say that we should tighten monetary policy. I would not want my views in that case to be taken as acceptance of the kind of inflation prospects that we are being presented with. I think that outlook is totally unacceptable. I didn't view the reduction in the federal funds rate on January 31 as an insurance policy against the downside risks in the real economy. The way I thought about it was that, on the basis of the information we were getting, the equilibrium real funds rate appeared to have moved down from what I felt was an appropriate level, and to avoid a de facto tightening of policy, the nominal funds rate needed to come down from the 5-1/2 percent level where it had been since November 1995. I think Don Kohn is correct in his assessment that more recent developments have reversed that decline in the real funds rate, and had I anticipated those developments, I would not have supported the 1/4 point reduction on January 31. But I also am not persuaded that this strength in the economy is likely to be enduring enough that we need to move the funds rate back up to where it was before January 31. So, I support a no-change, symmetric directive, though with considerable concern about how it will be interpreted.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Several issues have been talked about around the table, and in the end people have to make their own judgments. With regard to the issue about the economy and the structure of the economy, most of the models, which I think the Greenbook reflects, clearly indicate that we should have had accelerating inflation over the last couple of years and are likely to have accelerating inflation going forward. But the actual experience in the last couple of years has not been particularly consistent with forecasts based on those models. So, our dilemma really is one of being open-minded to the possibility that there are some structural changes going on versus getting caught up in wishful thinking because tightening policy is always more difficult than easing. It is easy to fall into the trap of finding excuses for not tightening, but my sense is that there is enough evidence over the last year or so to cause us to be more open-minded about the prospect that the economy may indeed be less prone to inflation. I think there is something to that hypothesis, but we have to be very careful about getting carried away with it.

On the stance of policy, if the federal funds rate were a couple of percentage points lower or even a percentage point lower, I would be more persuaded that now is the time to act. But I don't know whether current policy is a little restrictive or a little stimulative. My sense is that it is probably broadly neutral and therefore that we are fairly close to wherever we need to go. Based on those reasons, not out of any overwhelming conviction that I am right but after trying to weigh the evidence and making judgments that are a matter of both logic and intuition, I come down on the side of no change at this meeting, alternative B.

On the issue of symmetry or no symmetry, I could support either. I don't have strong feelings. On balance, I prefer symmetry mainly because I can't imagine that you, Mr. Chairman, would make a decision to move toward tightening in this particular environment without a consultation with the Committee. Therefore, I think the operational value of asymmetry in these circumstances is essentially worthless. Looking ahead, since we do have a lag on releasing the minutes, I think asymmetry could convey the wrong impression of where we are when the minutes are made public six weeks from now. I would prefer to keep our policy options very open, debate policy again in July, and make a judgment then without having the added issue of an asymmetrical directive at this meeting exert any influence on that decision. So, I come out with "B," symmetric.

CHAIRMAN GREENSPAN. I would like to concur with what several of you said regarding a telephone consultation. If events in the intermeeting period differ significantly from what we now expect, then certainly we ought to be talking on the telephone to see what, if anything, we want to do then. Governor Kelley.

MR. KELLEY. Mr. Chairman, as I said a little earlier, I think we are approaching but are not quite yet at a watershed, and as a consequence I don't have a view at this point concerning what way the water is going to flow when it flows. Clearly, there has been a shifting of the risks to the up side. On the other hand, it is a clearly plausible prospect that we will get a distinct slowing in the expansion rather soon. If we do get that slowing, it seems to me that the history of the past two or three years has to give us some pause about just how "baked in the cake" an inflationary rise may be. It could well turn out that if we get a distinct slowing, we will continue to see a pattern of stable inflation. At any rate, it doesn't seem to me that time is of the essence at this point. I think "watchful waiting" makes good sense. I prefer symmetry for precisely the reasons that Ed Boehne just stated, and I won't repeat them. But I must say that, for all of this, I am sitting very lightly in the chair about this business, and I would not object to asymmetry.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. Long-term rates are up substantially and the dollar is up a little, so we already have had some tightening in a sense. Don and, I believe, Al Broaddus said that a tightening of the fed funds target right now is unlikely to affect long-term rates the way such a tightening did in early 1994. I agree with that, but we didn't expect the impact in 1994 either. Also, there is a big difference between the present 5-1/4 percent funds rate target and the 3 percent target that existed then. Our policy stance is not so clearly easy now in my opinion. Also, it would bother me somewhat to base a tightening move on output and employment growth developments. Inflation is up overall, but its rise has been mainly in measures that include energy and not in core inflation. I think inflation is what we ought to be looking at more than the real sector. I agree with your proposal for no change with a symmetric directive.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your recommendation for "B," symmetric. My preferred policy as this stage is cautious inaction. I guess that's called "watchful waiting." As I indicated in my earlier comments, the current level of long-bond rates and the stronger dollar seem sufficient to me at this stage to contain the evident upside risk to spending. This level of long rates does seem consistent in my view with the maintenance of the funds rate at its present level, at least for the time being. The market certainly perceives some chance that the funds rate will need to rise this summer and next fall, and so do I because I think the risks have shifted. But the market is not demanding or even expecting such a move today. Market participants would be surprised, and I think it could provoke an excessive adjustment in long-term yields.

I certainly understand the reasons for wanting to move in advance of an increase in inflation. I agree with that reasoning, and I definitely do not object to the reasoning that is incorporated in the Greenbook about the inflationary process. But I share some of the doubts that the Chairman has expressed so well, and also Presidents Boehne and Stern. We do not understand fully what is going on in the labor market as evidenced by the errors in our earlier inflation forecasts, and I would like to wait and get a little more information. If the current Greenbook forecast is accurate, we will soon see clear evidence of an increase in compensation growth and an uptick in core inflation. When we see that, I think we definitely will need to respond. The staff's financial indicators package now routinely depicts the recommendations of Taylor's rule. This is a rule of thumb that I regularly consult as a very rough guide to reasonable policy. I don't mean to say that I think one should follow this rule religiously, but according to that rule--and a number of you have made this point--policy is roughly appropriately positioned at this time. It seems appropriate given current inflation and resource utilization. But the chart also indicates that it will be appropriate to tighten if the Greenbook forecast materializes, and I accept that conclusion.

With respect to the symmetry issue, I prefer symmetry for the reasons that have been explained by Vice Chairman McDonough and President Boehne.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. "B," symmetric. Although I believe that the risks have moved toward higher inflation, I do think that long-term rates are exerting some restraint. I would go with symmetry because if we were to make a change, it would be a change in direction, and I think a phone call would be appropriate.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I listened very carefully to your argument regarding the downward pressure that is now being put on prices. The model that crept into my head was what I will call the secular versus the cyclical factors. There are some secular changes occurring in the economy such as a decline in unionization and the spread of different kinds of retailing. These changes have put downward pressure on the capacity of the economy to increase prices. I have to believe that the secular trend is probably not a permanent one, and the question that we are facing is when it will come to an end. I agree with the Greenbook and with the majority of the people at the table that cyclical pressures are pointing toward more inflation. The question is whether the secular trend will keep the cyclical pressures from adding to inflation.

I have just one data point, not enough to base a decision on, and that is some information where I shop a lot! Actually, this information does not come from my shopping experience, but from the company itself. Over the last two years or so, they have been cutting prices on the average of 2 to 3 percent a year. That is partly an effort to gain market share and partly, I believe, the result of new developments in retailing. That policy has now changed. They have stopped cutting prices and are now starting to increase them, albeit very modestly. While this is only one data point, it does suggest to me that the secular factors are probably coming to an end. We have benefited from them for a long time.

The second issue is about events. I can't imagine any forthcoming economic event that is going to change anybody's point of view. What future statistic is going to cause us to move? There isn't one. So, I am not expecting the need for a telephone conference, and I don't think anyone else does either because there just is no number that would change something fundamental in this period. The reason is that we are not in an emergency kind of situation. When we tightened policy in 1994, I defended the move even though the natural rate was below the unemployment rate. The reason was that if we had waited for inflation to get embedded into wage rates, it would already have been too late and we would have needed a recession at that point to get the inflation out of wage rates. So, I don't think we should be driven by events. If we actually are looking for a reason in the ECI or in wage rates, it will be too late when we see it. It is my hunch that nobody here knows anyone who is expecting to cut some salary. The betting has to be that the salary is going to go up.

Having said all that, I have one hunch and one observation, and that is not enough for me to support an increase in rates today. But given that we are not driven by events, I am not sure that that is the basis on which we should decide symmetry versus asymmetry. As I listened to the comments around the table, I detected a strong undercurrent of unease. So, I am in concert with Jerry Jordan's observation that perhaps symmetric is not the way to go. We should take note of what is happening, and even though I favor symmetry procedurally, I would prefer "B," asymmetric at this point.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. It's a very close call, Mr. Chairman. I was in the group that did not favor a reduction in January, but I don't necessarily conclude that that means we should reverse that move today. I think the risks are clearly on the up side for output relative to potential. We all have expressed concerns about the inflation outlook. That outlook boils down in my judgment to two things: One is food prices and the other is wages and unit labor costs. On the food-price side, I think the outlook is uncertain. It is not clear how much of the increases in grain prices will be moving forward into food prices. I thought the analysis in the Greenbook was particularly helpful in showing that if food prices do increase, they will seep into the overall price level. As I think back, my experience in the 1970s is that increases in food prices tend to have a much greater impact on the overall price level than people expect. It just seemed then that everything started to go wrong and kept going wrong. If food prices do increase, I suspect that we will relive that experience and have more of a problem than people expect. That conclusion is not based on any econometric model; it's just based on my personal instincts. In fact, our econometric model at the Chicago Bank is slightly more optimistic than the Greenbook on the inflation outlook.

I think developments on the wage and unit labor cost side will be extremely important for policy. It would be helpful to have more information there, but I am not sure we ever have enough information. Something obviously different is going on. I think there are some faint indications that wages may be rising more rapidly, but as you said, Mr. Chairman, we clearly do not have enough evidence to reach a firm conclusion. On balance, I come down in favor of no change, but I would prefer an asymmetrical directive.

CHAIRMAN GREENSPAN. President Guynn.

MR. GUYNN. Mr. Chairman, I support your recommendation for alternative B, and for the reasons that Ed Boehne articulated I, too, would prefer a symmetrical directive. Being last or near last to speak, I won't repeat all the arguments that already have been made. One of the things that got a good bit of discussion in the earlier go-around was the run-up in oil and grain prices, their impact on the CPI, and how much weight to give to that. On that point, I have had to remind myself over the last couple of months about an important feature of the CPI--namely that, as a fixed weight index, it tends to overstate inflation when we get the kind of relative price changes that we have seen recently. Since a fixed weight index does not capture short-run substitution effects--and someone talked about that briefly during the earlier go-around--such an index does tend to show prices going up quickly. We know that what really happens is that some substitution effect will hold down the increase, although sometimes with a lag. On that point, I would therefore give somewhat less weight than do some others to the run-up in both oil and gas prices.

In preparation for this meeting we talked some about what we can learn from the yield curve, a subject that also came up this morning. There are a lot of interesting questions there, but I still am not persuaded that the steepening in the yield curve that we have seen recently provides sufficient evidence that an unchanged funds rate constitutes an accommodative shift in our policy. In sum, I would prefer to stand pat, observe developments very carefully over the period ahead, and be ready to move at our next meeting or before if we begin to see some of the inflationary pressures that people around the table have noted could happen.

CHAIRMAN GREENSPAN. Thank you. You were the last speaker. The consensus of voting members is clearly "B," symmetric, and our secretary will read the appropriate directive.

MR. BERNARD. The draft wording for the operational paragraph is on page 13 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes

Vice Chairman McDonough	Yes
President Boehne	Yes
President Jordan	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President McTeer	Yes
Governor Phillips	Yes
President Stern	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. We will now return to Don Kohn's query. Do you just want to give a short summary so people can respond to it?

MR. KOHN. I was thinking about the upcoming July meeting and recalling the Committee's discussion in February about paying a little more attention to its long-run objectives, in particular its inflation objectives. Taking into account speeches such as the one that Vice Chairman McDonough made on this subject, it struck me that it might be useful for the Committee members to discuss where they expected to be in 2-1/2 or 3 years in terms of those objectives. That would be in addition to the usual discussion leading to the selection of monetary aggregate ranges that the Committee is still required to establish under the law. The discussion might surface some of the pros and cons of this longer-run look at policy. So my proposal, Mr. Chairman, was that Committee members, in addition to the usual 1996-1997 forecasts that they would turn in for inclusion in the Humphrey-Hawkins report and that you would discuss in your testimony, also submit 1998 forecasts of real growth and inflation. The purpose would not be to publish those additional forecasts, but rather to help structure the Committee's discussion. The other point I tried to make is that, if the Committee members decided to go ahead with this, it would seem to me that the 1998 forecasts would incorporate what the individual members thought ought to occur. They would be more in the nature of goals necessarily than forecasts and would be based on the monetary policy that the members as individuals would pursue if they did not have to take account of their colleagues around the table.

CHAIRMAN GREENSPAN. Can I just amend that slightly? I think you also would want the 1997 forecast on the same basis.

MR. KOHN. Well, the members have to submit 1996 and 1997 forecasts in July 1996.

CHAIRMAN GREENSPAN. What I am trying to get at is that I don't think we want a 1998 number unless it reflects a desired outcome achieved through an appropriate policy. If you have a 1998 number that is the result of your individual policy, it also would be useful to have a forecast of 1996, 1997, 1998 on the same basis. That would highlight the difference between the way we normally have been doing these projections and what your policy would produce.

MR. KOHN. That has always been an ambiguous issue and one that I think has produced some confusion in the past when the Committee has discussed an extension of its projections. When you are asked for your 1996 and 1997 forecasts, you are asked to make your own assumptions about monetary policy.

CHAIRMAN GREENSPAN. They are assumptions of what the members think monetary policy will be, not what they would like it to be.

MR. KOHN. No, we have asked the members to base their projections on what they think an optimal policy should be.

CHAIRMAN GREENSPAN. How would you differentiate between the current projection and the new one?

MR. KOHN. When you are projecting 1996 and 1997, obviously much of what is going to happen, even if you were to run your optimal monetary policy, has already been "baked in the cake," given the ongoing trends in the economy. It seems to me that by the time you get to 1998, you have had enough time to adjust your individual monetary policies to look at 1998 as a goal.

CHAIRMAN GREENSPAN. That's clear enough.

MR. PRELL. I find the distinction a little awkward myself, having dealt with these numbers. What I have always found strange was that no one changed the numbers after the discussion at the meeting, which may have given people a clearer impression of what the Committee was up to. But the numbers stood as they were, presumably as numbers that were based on your optimal policy prescription. To divorce that from what is possible in your minds would seem pretty strained to me. So, I take this as a matter of emphasis to remind you that, especially for forecasts that extend further out in time, you should be thinking about what you want to achieve and not just producing some forecast based on current conditions, which is what some people have done.

MR. PARRY. But how are the numbers characterized in the Humphrey-Hawkins testimony? My recollection is that they are characterized as what the FOMC expects to happen.

MR. KOHN. Pretty much.

MR. PRELL. We indicate that they are consistent with the monetary ranges that the Committee selected and so on. So, they presumably are based on some policy plan. That is what the Humphrey-Hawkins Act calls for.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Don, when you use the word "forecast," you immediately put me off because it is inconsistent with saying "goals and objectives." In principle, of course, I think we ought to provide numbers to indicate what we are trying to achieve in 1998 and beyond in order to maintain the purchasing power of the dollar. It is simply inconsistent to have the Congressional Budget Office or the Administration publish inflation assumptions through the year 2002 on which to base a budget without any information as to whether or not those assumptions are acceptable to us in terms of the way we gear our policies. If the numbers that go into that process do not come from us, they should at least be influenced by us. I would like to put out numbers on inflation goals that we intend to achieve. However, as we have seen in these discussions before, if the number is to be 3 percent inflation for 1998, I don't want to publish it. I have a real problem with agreeing to publish a number if it is one that is going to reflect somebody's best guess as to what the dynamics of this Committee and interactions from some models will produce rather than a clear and attainable goal for reducing inflation.

My second problem, though not a new one, is the framework. If we supply a number for inflation, my own number would be 2 percent for 1998, and then the staff puts together a matrix that indicates how many people would have to be thrown out of work and how much output would have to be sacrificed to get to 2 percent inflation in that year, I am not going to want to publish that either. Perhaps the staff could at least humor those of us with analytical frameworks that differ from the gap or the NAIRU approach by including a reasonableness check. It would say that to achieve a goal for inflation--I will use 2 percent in 1998 as an illustration--one would need a specified growth in productivity over the interval to 1998. The staff also would indicate what counterpart reduction in the natural rate of unemployment would occur and provide some idea of the rate of sustained economic growth that would be consistent with reaching the inflation goal without reference to the notion of a Phillips curve tradeoff or sacrifice of output. Then, I and perhaps others could look at that analysis and decide whether it was a reasonable approximation of what was going on in the economy in terms of faster growth in productivity, the result of all of the investments taking place, and faster growth in capacity than allowed for in the staff model. I could decide whether I was willing to base policy on it. At least I would have a range in which to work.

MR. PRELL. President Jordan, I figured that that was what your GDP forecast would embody. Are you asking the staff to take each of the members' forecasts and rationalize them in terms of productivity?

MR. JORDAN. Not each one.

MR. PRELL. Each of you would have a different model and different relationships.

MR. JORDAN. No, but you could do it in terms of a range. We are not talking about a GDP forecast. The question is how much would productivity and capacity have to increase over and above what you have in your assumption to be consistent with moving toward 2 percent inflation--whatever unemployment rate falls out of that, perhaps a NAIRU of 4-1/2 percent or whatever, I don't know what the number is going to be--without sacrificing output and without creating a gap. I know your framework says that given where we are, an objective of 2 percent inflation requires us to raise the unemployment rate above the NAIRU and to reduce output below potential to create a gap. I don't want to do that.

MR. KOHN. Two points, President Jordan. First, I think I tried to emphasize in my earlier comments that your 1998 forecasts or goals would not be published for at least five years, unless you decided otherwise. Secondly, I think it might be useful if you chose to submit written notes to explain how you arrived at a particular configuration of GDP and inflation. The staff would then be more than happy to try to present a fuller explanation of where the goals came from.

CHAIRMAN GREENSPAN. I think the storm is really moving in. Maybe it would be wise for us to continue this meeting after lunch. We will still be in the meeting until we finish this agenda item. Let us take a temporary break so that everyone can get lunch. Then, when everyone is back, we will continue our discussion.

[Lunch break]

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I was amused when Don brought this topic up because I was going to suggest something like this, as I and others have done in the past. It is a good suggestion in that it represents a starting point for a dialogue about an issue that we need to talk about as a Committee. I would view it just as a starting point. Ultimately, I think we ought to aim for a longer-run goal with respect to inflation, maybe five years out or something like that, and we ought to communicate that goal to the public. I would not expect us to get to that point in this first discussion, but I regard it as very constructive to begin the discussion. Jerry Jordan touched on the reasons why it is so important. In my opinion, one of the most significant aspects is that, in circumstances like the present, we have inflation expectations that are quite volatile. It seems to me that if people were interpreting incoming data against the backdrop of a central bank that had established some longer-term goal for bringing inflation under control, inflation expectations might be less sensitive to the incoming data. If ultimately we got to the point of communicating a reasonable goal with respect to inflation over the long term--I don't mean necessarily as a result of the discussion we might have at the July meeting--I think that would increase our credibility, assuming we acted in the appropriate fashion to deliver on that goal. In my view we are to some extent paying the price right now for not having such a goal. The opportunistic approach we are taking in the fight against inflation to achieve our ultimate objective of price stability is having an adverse effect on our credibility. That is reflected in expectations of higher inflation and interest rates. People are not certain where we are headed, and they are worried right now that the next change could be more inflation, not less. In any event, I applaud Don for putting the idea on the table. I would support his proposal.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, I share Don's ultimate goal, but I do not think that his recommendation is a helpful way to get there. I believe that the appropriate goal of monetary policy is price stability and price stability only. I further believe that at some stage we have to define price stability and that the best way for people to understand it would be for us to connect it with a number. In order to have any notion that that number is something other than what we think we are likely to achieve, given what is going on in the economy at the moment, we have to push it out at least three years. And therefore our number for the second year out is an uneasy compromise between what we think is really going to happen in relation to today and what we are seeking to achieve. So, two years is too short a period to be useful in achieving an objective, and therefore I think it would be counterproductive to establish such an objective. I would much prefer that we have an unfettered debate in July. I am very much in favor of a debate on the issue of where we think we ought to be going, but I would not complicate that debate with a big row over who has 1998 right or wrong. I think that would obfuscate the real issue, which is whether we should agree on price stability as the goal and how we should define price stability. So, I am in agreement with where I think you want to go eventually, Don, but I think your specific recommendation is counterproductive.

CHAIRMAN GREENSPAN. Are you suggesting 1996 and 1997 and 2000?

VICE CHAIRMAN MCDONOUGH. No, I would say that, if we wanted to do this and we had had the debate beforehand, we would say the rest of 1996, 1997, 1998, and 1999.

CHAIRMAN GREENSPAN. What I am trying to say is that if you are looking for an extended period what you want to do is to eliminate part of the projection.

VICE CHAIRMAN MCDONOUGH. Yes, correct.

CHAIRMAN GREENSPAN. So it could be 1996, 1997, 1999 if you wanted to do it that way.

VICE CHAIRMAN MCDONOUGH. That's right, exactly.

CHAIRMAN GREENSPAN. I don't know how you get from your last forecast to your ultimate goal, but it's left a blank because that is where the most difficult transition questions are, and at this point it would obscure the ultimate goal to fill in that blank.

VICE CHAIRMAN MCDONOUGH. You made what I was thinking infinitely more clear. Thank you.

CHAIRMAN GREENSPAN. I did? [Laughter] President Hoenig.

MR. HOENIG. Mr. Chairman, I will repeat a little of what Bill just said. We have a goal for inflation and maybe we should define more clearly what we mean by price stability in the long term. Our discussion so far today has shown the difficulty of putting that in 1998 terms. We would spend a lot of time discussing whether we have a forecast or goal and not a lot of time on whether it is consistent with price stability. We would be right back where we are anyway. So, if we go with the proposal, I think it will create more confusion over time than it will provide clarity.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. I think I am an opportunist. I am proud of being an opportunist, but the thing I don't know is when the opportunity is going to present itself. We are not going to induce a recession, but we know the business cycle is going to produce one. When it does, then inflation will come down. I don't know if that will occur one or two business cycles from now. Perhaps the year 2000 is a good year for a goal; perhaps "ultimate" is another desirable goal; but I would not use 1998.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. I agree with Governor Lindsey. I think this is a discussion that we definitely need to have to clarify what we mean by price stability and what strategy we have in mind to get there. I am also concerned, especially given my interest in an opportunistic strategy, that it would be awfully hard to fill in the boxes relating to what I would expect in 1998. If we extended the horizon out a little longer to, say, the year 2000, I would find it easier to fill in the boxes and participate in our discussion.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I would like to associate myself with Governor Lindsey and Governor Yellen as an opportunist. I think there are a couple of other problems with this exercise. When we are looking ahead in terms of an expected result, that is a forecast. We come out with a point estimate forecast for that period in time. I think setting a goal is a different exercise. For one thing, people set goals differently. One of the pleasures of my job is that I get to discuss goals with all 12 Reserve Banks. They all have a different definition of how to set goals, and I don't know why that should not be true here. Some people believe in setting a goal that involves a lot of stretch, making it literally unachievable, so the issue is how close they can come to it. Others like to set goals that can be achieved with just a reasonable degree of effort. Both of those approaches are valid as long as people know which one is which, which one to follow. If we tried to establish a goal as a Committee of 19 people, I am not sure how we would do it.

Secondly, my working vision of how this opportunistic approach works is to get ourselves, as we have, into a downward sloping channel. We expect to have a little fluctuation inside that channel with regard to the performance of various indicators, but inflation would be pointed downward toward price level stability. How we articulate exactly what inflation will be as a point estimate at a future point in time using an opportunistic strategy is a little difficult for me to conceive. So, exactly how one sets a goal in a quantitative sense if one is basically of an opportunistic inclination is a little difficult for me to see.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. I agree that we have to clarify the difference between a forecast and a goal, and for that reason I agree with Governor Yellen that the further out we go in time, probably the better because I think it will be clearer that we are talking about a goal. But Mike Kelley also made the point, which obviously is a very important one, that people set goals in different ways. That is one of the things that would come out in a discussion about what assumptions people made when they set the goal, whether it really involved a stretch or whether it was something that they felt was achievable. I realize this could be a difficult exercise. We have 19 different people coming at it, but I believe we may learn something in the process. I think a discussion would be useful.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. This is an idea that we ought to pursue. I don't know if Don's suggestion is optimal, but we have to start somewhere.

I also think that we need to start with at least some structure. In this case I don't think it's critical whether we use a 1998-type goal or push the goal out a little in time. We have to start with some structure and some process because many of the questions that have been raised around the table have suggested, at least to me, that there are a lot of very difficult issues involved here. While we might agree that we are all in favor of price stability, we need to get beyond that general notion and decide what price stability means and, practically speaking, how we should go about implementing it, over what timeframe, and so forth. Those are difficult questions. They will get even more difficult as we really start to contemplate them, and it seems to me that we ought to get our feet wet somehow. What Don is proposing strikes me as a reasonable way to get started. We will see what kind of issues surface; we will see what we learn from this; and we may see how we can address issues like an opportunistic versus deliberate approach to disinflation.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I don't have any disagreement with what Don is recommending, and I think it can be done in terms of what one sets as a policy objective for a year like 1998. We use policy rules at the San Francisco Bank. We have some idea about what we think price stability means, and I think we would be able to do what Don is proposing quite easily. In a way it does put the cart before the horse because the real discussion is about what we as a Committee mean by price stability and over what timeframe we should seek to achieve it. Since we haven't been able to talk about that for 10 or 11 years, [Laughter] if Don's proposal gets us closer to it, I am all for it.

CHAIRMAN GREENSPAN. Would anyone else like to add to this discussion?

MR. BROADDUS. I agree with Gary Stern. I think this is a nice initiative. In my view, it's very important to start somewhere, and I am very glad that Don has suggested this and put it on the table. I also agree with some of the other comments, though, in the sense that I think focusing in a fairly unstructured way on 1998 is not the way to go. I believe we need to have a longer-term horizon. I would also suggest, Don, that the staff needs to put some structure on this kind of policy discussion just as you do on our long-term policy deliberations. The form that it usually takes is some set of alternatives. You do that with simulations to a degree already, but I am thinking about something that would be more structured in terms of a goal. That might beg some questions about what price stability is, but that's okay because we need to confront those one way or another in any case. If I may be a little more specific, it might be useful, say, with a horizon that runs out to the year 2000, to flesh out how you might interpret an opportunistic strategy under certain kinds of assumptions and what that might mean in terms of some price measure like the CPI. Perhaps as another alternative, you might add something that is a little more like our traditional inflation targeting with more specific numerical goals, year by year. That kind of structure might allow us to get a little more quickly to some of the questions with which we really need to grapple.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. There was a wonderful quote by Ed Boehne in the research paper that we got on opportunistic strategies. It went along these lines: Well, we are where we are; sooner or later we will have a recession; we don't want a recession; but if we can work things in a way that takes advantage of the inroads that we have made against inflation and hold the line to the next cycle, then we will achieve a pattern of every cycle having lower rates of inflation than the previous cycle, even at the cycle peaks. To me that is the operative definition of an opportunistic strategy, but it raises the issue of whether or not we can sit down and say, okay, by the year 2000 I anticipate that we will have had at least one recession and have made the same inroads into inflation that we made in the last recession. Therefore, my goal for the year 2000 is 2 percent inflation rather than 3 percent. I find that level of precision difficult to deal with. We need to have this discussion about what we mean by price stability. Does a price stability goal mean holding the line where we are and taking advantage of opportunities to get inflation lower, or does it mean some forward-looking policy to drive inflation down with all that implies about how we measure it. There are a lot of issues having to do with what are we talking about when we discuss inflation measures. We know there are a lot of problems with the CPI. What number are we going to look at when we say we have achieved victory? It's only part of the discussion, but I think we need to have it. I don't know whether all of us giving you a specific number incorporating a lot of different assumptions in "X" year has to be the way we start. We need to start talking about this, though.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I agree with President Minehan. I think it will be useful to have the discussion. I generally prefer an open-ended, longer horizon for a goal, but starting the discussion is what is important. We need to have some kind of discussion about what price stability means and what time horizon we are talking about, and if what gets us started is thinking about 1998, that's okay with me. My preference would be to base the discussion on a longer-term horizon than 1998, but I think getting started is more important.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I hope that we can have two discussions. I would set aside the question of strategy and discuss it sometime later because I think the two different approaches to strategy raise a lot of other issues. So, confining the discussion to our goals and objectives and the time period for achieving them would be very useful.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I think the discussion would be quite useful. But starting it with a number doesn't strike me as the way to do it. We ought to have a broader discussion on the issue of price stability, what we mean by it, and how we can get there. I think that if we have the substantive discussion, then numbers will fall out. But if we reverse the order, I think we will end up with a heavily philosophical discussion. So, I support the notion of having a discussion and focusing on the substantive question, and I would leave the issue of numbers for a later date.

CHAIRMAN GREENSPAN. Does anyone have anything to add? President McTeer.

MR. MCTEER. I'll use my turn to compliment the chef on these cookies! [Laughter]

CHAIRMAN GREENSPAN. That was the definitive end-of-meeting remark! I'll remind you that our next meeting is on July 2 and 3 and if events require, we will meet sooner by telephone communication. Hopefully, at some point we will have a broader telecommunications capability, but at the moment we are limited to telephone communications.

MR. KOHN. Mr. Chairman, we were hoping even before we had this discussion that we would perhaps have time at the July meeting--probably at the end of the meeting--to discuss the swaps issue, which we have kept pushing off. Hopefully, we will have a full Board by then, but who knows. We were thinking of starting that meeting earlier, say, at 1:00 p.m. on July 2. Perhaps we could start the meeting with lunch. Would that be--

MS. MINEHAN. All the major unresolved issues of monetary policy in one meeting? Swaps and price stability?

CHAIRMAN GREENSPAN. Does anybody have a problem with 1:00 p.m.? [Secretary's note: No member indicated a scheduling conflict.]

CHAIRMAN GREENSPAN. Let's now end this meeting.

END OF MEETING